Overview

- Why is transfer pricing a hot topic now – and how does it impact you?
- How do the IRS, overseas tax authorities and states audit transfer pricing?
- What are some best practices for addressing transfer pricing issues?
- U.S., global and state transfer pricing developments
Is Your Company Paying Its Fair Share of Tax?

“Why does Starbucks manipulate its accounts to avoid tax?”
-UK MP Margaret Hodge, 11/12/12

Transfer Pricing – Why Now?

Apple wasn’t satisfied with shifting its profits to a low-tax offshore tax haven. Apple successfully sought the holy grail of tax avoidance.”
- Senator Carl Levin, (D-MI)
5/20/13
Transfer Pricing Dilemma

Practical dilemma:
- German auditor challenges when prices on parts and services are too low
- IRS challenges if the transfer prices on intercompany transactions are too high

Big Picture Transfer Pricing

- “Arm’s-Length Standard” – Prices charged between related companies should be the same as what would be charged between unrelated companies
- Rules apply to prices charged for goods, services, royalties and loans
- Two tax authorities can audit the same transaction
- Fortunately, transfer pricing principles are broadly similar on a global basis
Big Picture Transfer Pricing

- Intercompany pricing drives how much income tax is paid by country or by state
- Tax authorities revisiting transfer pricing as an ideal way to protect tax base
- Easier way to raise tax revenue when raising tax rates is not an option
- Not paying your fair share = large tax bills

- Goal – multinationals must pay their fair share of income taxes in every country

Transfer Pricing – Why Now?

- Globalization – many more companies operate internationally now
- US was first to introduce transfer pricing penalties in 1996, now over 100 countries have rules in place
- High-profile multinationals facing public criticism for complex tax structures
- Middle-market companies now being audited in the US and overseas
Transfer Pricing – Why Now?

- Who has transfer pricing issues?
  - General Electric, Google, GM, Wal-Mart, Caterpillar, Apple, Starbucks

- A US company with a subsidiary in Ontario, Canada – or any country
- International companies with a subsidiary anywhere in the US or other countries
- Companies expanding internationally for the first time
- Some companies with operations in multiple states (state transfer pricing)

Transfer Pricing Example

Pharma-US
Cure for the Common Cold Developer

Pharma-UK
Cold Remedy Distributor

- SVC-US is earning $1 million in profit on new cold remedy
- SVC-UK is earning $11 million in profit on distribution activities

Question:
- How would HMRC (UK) and the IRS approach this issue?
How Do Companies Operate in an “Arm’s-Length” Situation?

IRS concludes that Pharma-UK should only earn a nominal profit for distribution: Treas. Reg. § 1.482 (and similar approaches adopted internationally)

Assume a total taxable income adjustment of $10 million
Additional income tax owed - $10 million x 35% = $3.5 million
Plus non-deductible penalties of 20% on additional tax owed $700,000

$4.2m + interest + state taxes + potential double tax (penalties start at $5m)

Taxable income adjustment of $20 million (or more)- 40% penalties:

Transfer Pricing Double Tax Resolution

- Transfer Pricing disputes are highly fact intensive exercises.
- Competent Authority negotiations average ~ 2.5 years.
- No guarantee that complete double tax relief will be granted.
- Overseas tax authority adjustments work in similar fashion.
Do Smaller Companies Face Risks?

SEC Filing - RBC Life Sciences discloses Canadian Transfer Pricing Audit

- Public company $25m in revenue and $4.5 million in Canadian revenue
- Canada Revenue Agency adjusted transfer pricing due to consistent losses
- Company lost $940,000 in Canadian tax NOLs over 2009-2011
- Was paying tax in the US while incurring losses in Canada

Key Question:
Would an independent distributor continue to purchase lossmaking products?

Source: KPMG

Transfer Pricing Growth by Country

Source: KPMG
Transfer Pricing Real-Life Example

When does this typically happen?

- SVP has a standard cost plus policy in place
- SVP is operated as one “borderless” business
- What if the plant manager’s bonus is affected by transfer pricing?

Where Do Companies Struggle?

Every cross-border transaction subject to audit by two or more tax authorities

- Tax authorities can adopt opposite positions

Global and local management may have different priorities than tax compliance

- Bonuses/Compensation may depend on transfer prices
- Local management may be focused on satisfying local tax auditors
- Transfer pricing approach may be a company’s last-on-the-list decision

Intercompany transactions may be overly complex for the size of the business
How Can You Start Assessing Transfer Pricing Issues?

Many tax authorities assess transfer pricing by reviewing profit margins of subsidiaries
- Subsidiary losses/NOLs often audit red flags
- Large Profits in Subsidiaries also red flags

EBIT as a percentage of sales in each subsidiary
- EBIT/Sales is commonly used to assess whether profits are “commercially realistic”
- Often used for benchmarking “comparables”

Transfer Pricing Audit Example

U.K. Parent Food Equipment Manufacturer
U.S. Subsidiary Distributor

- IRS decided to challenge $3m in UK management service fees
- CEO/CFO salary charged was ‘excessive’

Response- USCo is essentially too profitable
- Follow-up discussion with the client about the company’s global effective tax rate
Transfer Pricing Documentation

Companies can prepare transfer pricing documentation to justify intercompany pricing to tax authorities:

- Explain the business operations in detail on both sides of the border
- Explain how industry developments affect the business
- Analyze financial information and transactions
- Show transfer pricing is arm’s-length through “Best Method” economic analyses

“Best Method” is often a comparison of subsidiary profits with "comparables"

How Do Companies Manage Risks?

A “contemporaneous” transfer pricing documentation report can mitigate the risk of transfer pricing penalties (Treas. Reg. § 1.6662-6(d))

- No transfer pricing adjustment = no additional tax, no penalties
- Ideally justifies pricing on both sides of a transaction to tax authorities

- Studies need to be prepared by the filing date of the tax return to be “contemporaneous”- and updated annually
- A profit margin benchmarking study may be a practical alternative
How Do Companies Manage Risks?

Documentation is the first, and best, opportunity to avoid an audit

- Reduces penalty risks if an adjustment is applied
- Documentation requested for every IRS tax audit – 30-day deadline
- IRS now has a new 2-year audit ‘roadmap’ process for transfer pricing

Rules of thumb:
- If documentation does not make sense to you, it will not convince an auditor
- Implement intercompany agreements to support TP approach

Potential Alternatives – Benchmarking Studies

For lower risk situations, an alternative to documentation may be a benchmarking study

- Business overview summary and calculate a range of profit margins for subsidiaries
- Not documentation, but provides a basis for establishing intercompany pricing
- Database search for public profitability data

In this example, profit target of 5.0% to 8.2%
Top and Bottom 25% excluded from “range”

<table>
<thead>
<tr>
<th>Company</th>
<th>Profit Margin</th>
</tr>
</thead>
<tbody>
<tr>
<td>Company A</td>
<td>16.3%</td>
</tr>
<tr>
<td>Company B</td>
<td>12.8%</td>
</tr>
<tr>
<td>Company C</td>
<td>8.2%</td>
</tr>
<tr>
<td>Company D</td>
<td>6.3%</td>
</tr>
<tr>
<td>Company E</td>
<td>5.5%</td>
</tr>
<tr>
<td>Company F</td>
<td>5.0%</td>
</tr>
<tr>
<td>Company G</td>
<td>0.3%</td>
</tr>
<tr>
<td>Company H</td>
<td>(3.2%)</td>
</tr>
</tbody>
</table>
What Causes Transfer Pricing Heartburn?

- Overseas subsidiary earns a 20% profit margin, but study says maximum of 5%
- Study prepared in 2010 is irrelevant for the 2015 transfer pricing audit
- Canadian TP study concludes that Canada is earning too much profit vs. the US
- Report is only a policy
- Transfer pricing study uncovers tax exposures during M&A due diligence review

Where Are Transfer Pricing Success Stories?

Tax Net Operating Loss situations can be great places to start

For example, RBC Life Science Transfer Pricing Audit

- Company incurring losses in Canada ($900,000) on purchases from the US
- Company paying tax in the US - $1.5 million taxable income

- Correcting the transfer pricing likely to reduce audit risks in Canada
- Correcting transfer price on sales to Canada may improve tax rate and cashflow
Important US Tax Forms Related to Transfer Pricing

Form 5471 - Information Return for US Persons with Certain Foreign Corporations
Form 5472 - Information Return of 25% Foreign Owned Corporation
Form 8858 - Information Return of US Persons with Foreign Disregarded Entities
Form 8865 - Information Return for US Persons with Certain Foreign Partnerships

- Disclose Intercompany Transactions with Foreign Corporations and much more
- $10,000 fine for each failure to file for each foreign entity

"Check-the-Box" entities are still subject to US & international transfer pricing rules
- Foreign Tax Credits can be disallowed under transfer pricing principles

International & State Developments
State Transfer Pricing Perspective

“Our large taxpayers are shifting profits outside of the state, and in very significant ways. . . some intercompany transactions [tend] to hollow out the corporate income tax base and the corporate income tax system.”

-Joe Garrett, Jr. Deputy Co-Commissioner Alabama Department of Revenue

New York University 34th Institute on State and Local Taxation, 12/17/15

State Transfer Pricing Regulations

- Several states have some regulations similar to US rules (IRC § 482) for transfer pricing
  - AL, DC, FL, GA, HI, IN, IA, KY, MA, NJ, NY, NC, PA, WI

- Concept – Taxpayer has been shifting profits out-of-state by manipulating transfer pricing
- The Multistate Tax Commission is hiring outside transfer pricing economists to conduct audits
Recent Developments

Organization for Economic Co-Operation and Development (OECD)
- OECD Transfer Pricing Guidelines sets standards for “arm’s-length” standard

The OECD is implementing a Base Erosion and Profit Shifting (BEPS) plan
- Biggest change is for companies €750 million in revenue globally
- Tax authorities can access how much in sales, income and tax are generated in each country
- Risk assessment - how much of the tax “pie” is my country receiving?
- For everyone, more prescriptive approach to transfer pricing documentation

OECD Country-by-Country Reporting (2016 Year-end)

Transfer pricing documentation – Country-by-Country Report

A. Model template for the Country-by-Country Report

<table>
<thead>
<tr>
<th>Tax Jurisdiction</th>
<th>Revenues</th>
<th>Profit (Loss) before income tax</th>
<th>Income Tax Paid (on cash basis)</th>
<th>Income Tax Accrued - Current Year</th>
<th>Stated Capital</th>
<th>Accumulated Earnings</th>
<th>Number of Employees</th>
<th>Tangible Assets other than Cash and Cash Equivalents</th>
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</thead>
<tbody>
<tr>
<td>Unrelated Party</td>
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<td>Related Party</td>
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<td>Total</td>
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</tbody>
</table>
OECD Base Erosion and Profit Shifting Program

- Enormous increase in tax return data collection and disclosure for multinationals
- Tax information can be accessed by any tax authority via tax treaty requests
- IRS starts requiring this data for 2017, but will accept 2016 voluntary filings now

BEPS also addresses numerous other complicated tax issues – 15 actions, including
- Digital economy taxation (internet sales)
- Excess interest deductions
- Permanent establishments
- Hybrid Mismatches
- CFC Rules

Final Thoughts & Takeaways
Best Practices

Review Profitability of Subsidiaries – all open tax years
- Earnings before Interest and Tax (EBIT)/Sales is the best place to start
- Focus on annual results
- Is the subsidiary earning too much profit or not enough?

Can the company explain how the transfer pricing is correct?
- Is there current documentation?
- Would the report/explanation make sense – on both sides?

Red Flags for Auditors

- Why does your company incur losses in this location? (or minimal profits)
- Why did your taxable income fall from last year?
- Why are there fluctuations in gross margins?
- Why do other locations generate more profits?

“We have a policy”/ “Always done it this way”/ “Downturn in the market” does not necessarily work
Transfer Pricing Takeaways

- All Companies with cross-border transactions have transfer pricing issues
- Tax auditors see transfer pricing as a great revenue raiser
- Start by reviewing annual profitability margins of subsidiaries
- “Does this make sense?” can identify problems prior to an audit
- Documentation is an option to defend transfer pricing

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