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# Navigating Transfer Pricing

*Understanding Transfer Pricing Issues and Using Studies to Mitigate Risk*

One of the more vexing issues facing modern businesses is the fact that most companies, both large and small, operate in multiple tax jurisdictions. With the internet in place, a smart-phone in every pocket, and access to the cloud from virtually anywhere, 21st century managers are in constant contact with customers, suppliers, and business partners in any state throughout the United States and in any country around the world.

As a result, a company of any size can find itself operating a multistate or multinational business. Products fabricated or purchased in one jurisdiction may be stored in another jurisdiction and sold to customers in a third jurisdiction. Any business may enter into a partnership, joint venture, or cost-sharing arrangement with allies in other states or countries. Support functions such as accounting, marketing, or R&D may be located in one place but provide services throughout the organization.

The challenge becomes how to determine the amount of profit earned in any given jurisdiction, and how to protect the company from aggressive taxing authorities who, after the fact, challenge the prices set for the sale of goods or the providing of services between related business units.

## Benefits of a Transfer Pricing Study

A transfer pricing study is a thorough review, usually conducted by an outside party, of the company's pricing policies and the documentary support for those charges. Such a study can produce a number of benefits to the enterprise:

- Reduce taxes and penalties by assuring that the company's transfer pricing policies comply with all requirements in the local jurisdiction, including meeting local documentation rules.
- Provide support for transfer pricing related deferred tax assets and deferred tax liabilities recorded in the company's financial statements.
- Identify opportunities to reduce the company's global effective tax rate by restructuring multinational operations.
- Identify opportunities to increase global supply chain efficiency by relocating operations or reorganizing legal entities.

## Governments Are Enforcing Transfer Pricing Rules

It is fair to say that transfer pricing is the number one global tax issue facing multinational businesses. The avowed goal of most transfer pricing regimes is to assure that the income taxed in a particular jurisdiction is determined using sound economic and business principles. No government wants to allow businesses to evade income taxes by inappropriately sourcing profits to low-tax jurisdictions—so-called "tax havens." Any government, rich or poor, well established, or more recently emerging on the international scene, does not want its tax base to suffer as a result of a business using questionable transfer pricing policies.

The U.S., and almost all of its major trading partners around the world, have transfer pricing rules that allow tax authorities to adjust items of income, expense, credit, or allowance in connection with transactions among related parties. The U.S. and most jurisdictions with transfer pricing regimes have instituted requirements that require businesses with related party transactions to develop and retain documentation supporting the arm's length nature of their related party transactions. Such documentation must be prepared in a prescribed format, that may vary by jurisdiction. Often it must be completed by the time the tax return is filed, reflecting the related-party transaction. If an adjustment is made by a taxing authority and the required documentation is not available, the company may face significant penalties.

In 2010, the Internal Revenue Service ("IRS") released the final version of its new Schedule UTP, Uncertain Tax Positions Statement. Schedule UTP is used by a corporation to report to the IRS Federal income tax positions for which the corporation or a related party:

- has recorded a reserve in an audited financial statement; or
- has not recorded a reserve because the corporation expects to litigate the position.

The schedule requires corporations to identify those uncertain tax positions that specifically relate to transfer pricing separately from other uncertain tax positions.

For 2010 and 2011, Schedule UTP applied to very large corporations—those with assets of $100 million or more. For 2012 the reporting threshold drops to $50 million and then to $10 million for 2014. Therefore, companies currently exempted from the Schedule UTP filing requirement will need to be prepared to file the form in the future. Also in 2010, the IRS reorganized its examination division, to include an international unit with a dedicated transfer pricing director and a dedicated chief economist. Since the reorganization, companies under examination by the IRS have seen an increase in the number of Information Document Requests relating to transfer pricing matters and more international agents being assigned to examination teams.

The IRS is not alone in its focus on transfer pricing. Typically, low-tax jurisdictions are not concerned about transfer pricing because companies try to shift profits into those jurisdictions to enjoy the benefit of lower tax rates. But recently Ireland, a relatively low-tax country, has begun to enforce a transfer pricing regime to prevent high-tax countries from pressuring businesses to shift profits out of Ireland.

While 25 years ago only a handful of countries had comprehensive transfer pricing rules, today, well over 50 countries have adopted some type of transfer pricing regime, and the number continues to grow. Failure to comply with local rules can result in additional taxes plus penalties.

It seems likely the number of countries examining transfer pricing policies will only increase. The Organization for Economic Cooperation and Development (OECD) and the United Nations ("U.N.") have each issued guidelines to assist countries in developing their own transfer pricing rules.

One factor that is consistent between the U.S. tax regulations, the OECD guidelines, and the U.N. guidelines is the need for contemporaneous documentation supporting how the transfer price was determined and that the price is within a range of what other parties charge in similar, arm's length transactions.

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### Transfer Pricing Is Not Just a Tax Issue

From a business operations perspective, getting transfer pricing "right" helps the company determine the profitability of its various operations. As a result, management can make better decisions about resource allocation and the appropriate award of financial incentives to key employees. By identifying current and potential competitors inside and outside the industry and benchmarking the company's financial performance relative to its peers, management can better assess its strategic and tactical business plans.

The Public Accounting Reform and Investor Protection Act of 2002 (more commonly referred to as Sarbanes-Oxley) created a new environment regarding corporate governance and Securities Exchange Act compliance.

Entities affected by Sarbanes-Oxley include those companies whose stocks trade publicly and all registered foreign companies. In addition, all non-public companies whose debt securities are publicly traded, whose equity or debt securities are registered under the Securities Exchange Act, who are required to file reports under the Act, or who have filed a statement for a public offering under the Act must comply with Sarbanes-Oxley.

Coverage under Sarbanes-Oxley also extends to any officer, employee, contractor, subcontractor, or agent of a covered entity. As a result, non-public companies who are contractors or subcontractors of a public company are subject to obligations and proceedings under Sarbanes-Oxley.

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Section 404 of Sarbanes-Oxley does not specifically address transfer pricing issues. However, it requires companies to identify financial reporting risks, ascertain related controls, assess their effectiveness, remediate any control deficiencies, and then retest and re-document those controls.

There can be situations where missing or ineffective internal controls over transfer pricing may have a material effect on a company's financial statements:

- If there is more than a remote likelihood that the IRS or foreign tax authorities will make a transfer pricing adjustment that would lead to additional tax expense that would be material to the company's financial statements; and
- If there is more than a remote likelihood that the IRS or foreign taxing authorities would impose, as a result of transfer pricing adjustments, penalties that would be material to the company's financial statements.

More recently, FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes*, has created another nontax reason for companies to review their transfer pricing. FIN 48 requires companies to evaluate their tax positions in a two-step process:

1. No tax benefit may be recognized in a financial statement unless it is more likely than not the tax position will be sustained on examination by the taxing authorities.
2. The amount of the recognized benefit is limited to the largest amount of the benefit that is more than 50 percent likely to be realized on ultimate settlement with the taxing authority.

FIN 48 necessitates a reevaluation of all transfer pricing determinations, with a focus on the sustainability of each.

### Transfer Pricing Studies Save Taxes and Reduce Risk

Many companies opt to conduct a review of their transfer pricing policies. Transfer pricing studies are typically conducted by experienced accountants and economists with a strong background in multistate and multinational tax matters. The objective of the study is to determine a pricing structure that will withstand challenge from the relevant taxing authorities and best serve the company's business needs.

A well-documented transfer pricing study allows the company to minimize risk, institute tax planning strategies, and maximize worldwide income. Companies may be able to increase net income by:

- locating business operations and earning profits in favorable tax jurisdictions; and/or
- locating business operations in areas that offer a lower cost of labor or other resources.

### What to Take Away From This Discussion

All governments—Federal, state and local, and non-U.S.—are looking for ways to expand the tax base without raising nominal tax rates. Businesses operating in multiple jurisdictions should expect to be pressured by taxing authorities to justify the allocation of revenue and expenses among jurisdictions. The result is uncertainty about transfer pricing positions which creates significant financial reporting and tax disclosure issues.

Transfer pricing is an issue that no CEO, CFO, tax director, controller, board member, or business owner can ignore. There are imminent reporting and compliance obligations. There is significant exposure to additional taxes and penalties. There is a very real possibility that the same profits could be subjected to tax in two or more jurisdictions.

A transfer pricing study is a tool that can minimize these risks. Combined with sound multistate and international tax planning, the company may be able to lower its overall tax obligation, reduce the effective tax rate reported in its financial statements, fully comply with its reporting obligations, and manage the profitability of its business operations at every location throughout the U.S. and around the world. ■

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