



COMMON TRANSFER PRICING MISTAKES

INSIGHTS

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Executive Summary

The Issue:

Despite the OECD's efforts to present a set of guidelines about transfer pricing aspects of business restructuring, taxpayers are still not always clear about their options, especially when trying to avoid disputes. The OECD is continuing its work on various BEPS (base erosion and profit shifting) action plan items as participating countries debate competing views and expectations regarding how the BEPS action items should be implemented. Transfer pricing documentation remains a topic of central importance and interest for stakeholders, with the OECD's proposed country-by-country reporting being a central feature (and central area of concern) for the new guidelines.

Consequences:

Corporate restructuring is undertaken by companies for a number of reasons, usually commercial, and there is often a tax benefit involved in doing so. However, there may also be a tax cost to a restructuring.

What Needs to be Done:

The fundamental tenet of transfer pricing (IRC Section 482) is that related parties shall transact at arm's length, implying that a related party transaction should reflect similar economic substance to a transaction undertaken with a third, or unrelated, party.

The Issue at Hand

The Internal Revenue Service (IRS) has issued a transfer pricing roadmap that is expected to impact the conduct of transfer pricing audits in the US. Other countries also have seen a number of important recent developments in the transfer pricing area as well.

The transfer pricing regulations adopt the arm's length principle as the standard for the evaluation of intercompany pricing. Transactions are said to comply with the arm's length principle when conditions imposed in related party transactions are comparable to those imposed by independent enterprises dealing with comparable transactions in comparable circumstances.

Generally speaking, the most reliable method of evaluating an arm's length price is to compare prices paid or received by independent firms for comparable property under comparable circumstances. When no such comparable pricing information exists, the approach most often used involves a comparison of profitability between the controlled firm and comparable uncontrolled firms. Such comparisons allow inferences to be drawn as to whether arm's length prices for services or intangible assets can be reasonably charged or incurred. Other methods may be applicable if comparable uncontrolled firm analysis is deemed unreliable.

Functional Analysis Mistakes

The allocation of income and deductions among taxpayers is driven by facts and circumstances. As such, a functional analysis is performed as an integral part of a transfer pricing study, specifically designed to consider the nature of the services, their risks and economic substance, and their operational role in the context of the corporate organization and its industry.

- Responsibility is not well defined
- Informal documentation and practices
- Operations, data collection, and accounting policies are misaligned
- Failure to identify which activities and intangible assets contribute to revenue and profits
- An overreliance on a specific function
- Failure to fully define the role of intangible assets specific to each product or service segment
- Transfer a valuable intangible for less than arm's length compensation
- Contract manufacturing structure to avoid subpart F income in foreign locations that do not have sufficient manufacturing activity
- Transfer of intangibles such as research and development related to a new drug and then argue that a disproportionate amount of the profit should be allocated to the low-or-no tax jurisdiction

Transfer Pricing Methods Analysis Mistakes

Transfer pricing regulations provide several methods for determining intercompany prices and require that the “best method” be employed to determine arm’s length pricing for each intercompany transaction. The best method is defined as the method that produces the most reliable measure of an arm’s length result for the controlled transaction, considering all of the facts and circumstances of that transaction.

Two primary factors must be considered in order to determine which method is best. The first is the degree of comparability between the controlled transaction and the uncontrolled transaction. Whether a controlled transaction is at arm’s length is usually determined by comparing the results of the transactions with the results realized by uncontrolled taxpayers engaged in comparable transactions under comparable circumstances. The second consideration is the quality of the data and assumptions used in the analysis.

A transfer price methods analysis includes, but is not limited to, the following:

- Determining and applying the best method for the services provided between/among related parties
- Determining and applying the best method for allocating the cost of the usage of the technology-based assets
- Determining and applying the best method for allocating the cost of the usage of the trademark and tradename
- Determining and applying the best method for allocating debt service costs
- Undocumented interpretations of the terms used in the inter-company agreements
- Informal documentation and practices
- One entity makes a loan or advance to another entity and charges no interest or does not charge an arm's length interest rate
- One entity performs services for another entity without charge or at a charge which does not reflect an arm's length payment
- One entity leases property to another entity at a rental charge that is not an arm's length rental charge
- One entity leases intangible property to another entity for no royalty fee or a fee that is not an arm’s length fee
- One entity enters into a cost sharing arrangement with another entity to share costs to develop intangibles, but all related costs have not been historically shared

- The use of hybrid structures, including hybrid entities or hybrid instruments to either exclude income from taxation or obtain double deductions/credits in various jurisdictions
- The use of comparable unrelated companies that are not relevant and do not represent near-equivalent operating or financial measures
- Imposing a “one-size fits all” allocation across all product and services

How Marshall & Stevens Can Help

Marshall & Stevens transfer pricing group includes an experienced team of economists and valuation specialists (PhDs, MSs and MBAs). Our team has the broad understanding of the U.S. Internal Revenue Service and foreign tax authorities necessary to implement defensible transfer pricing policies and procedures. Marshall & Stevens transfer pricing group specializes in creating optimal financial analytics to support compliance requirements.

We have handled cases in over 50 countries. Our experience includes the following:

- Advising clients on matters relating to the allocation of SG&A
- Providing significant experience with transfer pricing matters in the context of the Internal Revenue Service compliance assurance process (CAP)
- Developing solutions for clients to effectively implement structures and pricing strategies
- Addressing issues in the "commensurate with income" field for intangibles
- Assisting clients in establishing, documenting, and defending cost-sharing arrangements
- Providing operating structural recommendations for US companies and other multinationals while minimizing adverse transfer pricing and permanent establishment related exposure
- Assisting in establishing appropriate arrangements for product, process, and marketing intangibles, including cost sharing as well as transfers by way of licenses and sales
- Providing a unique approach to address manufacturing activities

Industries we serve include the following:

- Oil and gas and related petroleum refining
- Chemicals manufacturing
- Industrial equipment and products manufacturing
- Pharmaceutical and medical device companies
- Mining
- Computer and software design and manufacturing
- Consulting services
- Educational services
- Independent power
- Brokerage and trading operations
- Food service
- Consumer products manufacturing
- Retail operations
- Specialty manufacturing
- Technology

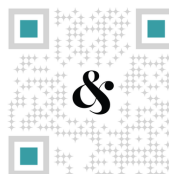
EXPERTISE IN ACTION

Founded in 1932, Marshall & Stevens provides valuation consulting, transaction advisory, and litigation support services. The firm's specialists are relied upon by businesses, investors, and advisors for analyses utilized in complex transaction and legal matters.

From the boardroom to the courtroom, Marshall & Stevens delivers clarity, independence, and results.

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