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Too Small to Plan for Global Operations? Better Think Again…An Introduction to Transfer Pricing for SMEs

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In 2008, the Organization for Economic Cooperation and Development said, “The rapid process of globalization is among the most striking features of the current economic landscape.” Since then, there has been an international explosion; in the intervening decade the scope of globalization has exceeded every expectation. The value of merchandise trade and trade in commercial services, now exceeding $20 trillion worldwide (annual number), according to the World Trade Statistical Review, is almost 40% higher than it was 10 years ago.

Simply put, companies of all sizes, including small to midsize enterprises (SMEs), are currently taking advantage of globalization to expand markets, attain resources and increase organizational knowledge. But there are certain realities to international business. Laws, regulations, customs and tariffs—as well as distance—can all conspire to make doing business abroad complicated. Historically, international business was the domain of large multinational enterprises (MNEs), which had more resources to plan, develop and execute global strategies, and to subsequently comply with the ever-changing complex web of local, regional and international regulations. Now, international markets seem to have become as easily accessible as the internet, and SMEs have gained access to the same opportunities as their bigger brethren.

The idea that SMEs – from a striving technology unicorn to the family-owned business – can adapt to changing environments and compete in a global environment with large organizations has become the norm, particularly as it relates to market development. However, in terms of planning and executing a global business model along with complying with the relevant regulations, SMEs may not have caught up to the big multi-nationals and could be exposed. This article paper will briefly explore one critical aspect, transfer pricing, where SMEs may be deficient and can easily get help.

Definition
A transfer price describes the price charged for tangible goods, intangible property, services or financing arrangements between related entities. Transfer pricing affects the profit allocation within MNEs and how much tax the company pays in each jurisdiction it operates in. As a result, it affects the total tax burden of a company. Transfer pricing applies to all cross-border transactions (and even in some domestic situations).

One-hundred and twenty countries and counting have adopted transfer pricing rules and regulations since the early 1990s and most countries require contemporaneous transfer pricing documentation to support their allocation of income and, therefore, their tax position. In the more recent years, the OECD’s initiative targeting base erosion and profit shifting (“BEPS”) has significantly raised the compliance burden for all taxpayers and also requires taxpayers to re-evaluate their existing tax structure. The substantial overhaul of the U.S. tax system also has a significant impact on international tax and transfer pricing.

A simple example of how transfer pricing works is provided below (US parent with Irish subsidiary):

- US parent undercharges Irish subsidiary for services and loans provided by US
- Creates lower taxable income in US and higher taxable income in Ireland
- Corporate federal tax rate in Ireland is 12.5% as compared to 21% in US
- Result is higher after-tax profits for combined organization (on a global basis), but less tax revenue for the US Internal Revenue Service

Implications
Getting your transfer pricing policy wrong can be expensive in many ways: double taxation may be the result, and penalties and interest could be imposed by a local taxing jurisdiction. It can also disrupt the operational integrity of the organization and inefficient or non-existing policies are a drag on the company’s shareholder value. Transfer pricing protocols are oftentimes highly subjective and require in-depth knowledge of a company’s specific industry. This includes understanding key value drivers, the overall supply chain, global strategy and creating a sound economic analysis. Failure to comply results in a high frequency of penalties – in some countries (e.g., Brazil, China, Indonesia, Japan, Malaysia), penalties are imposed in 75–100% of all adjustments – aside from reputational risks.

In Response
In order to avoid costly audits from taxing authorities, SMEs must develop an effective model for transfer pricing planning. There are no longer shields available for small businesses that may be exposed to compliance issues because of their (lack of)

international activities. Yet a successful resiliency plan which is effective and affordable can be developed. This is a process which should include the advice of qualified professionals. The downside for avoidance is the potential for stiff penalties and high legal costs and in some cases lost opportunities due to inefficient or non-existing transfer pricing arrangements. How does the SME owner or leader know if an investment in transfer pricing planning is warranted? Here are key areas to look at:

- Related party (branch or subsidiary) located outside of the US
- Company sells into more than one country
- Extraordinarily high or low profit margins at certain legal entities
- Profit margins vary significantly across legal entities or across years
- Legal entities located in low-tax jurisdictions with few or no employees
- Employees frequently travel to other countries or live in another country
- Company uses commissionaires or sales agents outside the US
- Company has extraordinarily high or low effective rate tax
- Company is preparing for an IPO, to be sold or to acquire
- Multiple affiliated legal entities in different states in the US or non-profit organization with taxable affiliate

Next Steps

With the assistance of competent professionals, the owners and leaders of SMEs can take proactive steps to address potential transfer pricing exposure and inefficiencies. It is fair to say that fiscal authorities want their fair share of the global profit pie generated by a multinational taxpayer. In that circumstance, the minimum outcome for a country is to protect the current tax revenue base. A better outcome for authorities is for a country to grow the revenues collected from multinational taxpayers. As a result, any reasonable standard in pricing or in evaluating the reasonableness of related party transactions must factor in this fiscal objective.

Transfer pricing is highly subjective. A sound policy requires in-depth knowledge of a company's industry; its key value drivers, supply chain, global strategy and developing a thorough economic analysis. This is an important opportunity for any SME owner or manager. Understanding the risks associated with transfer pricing exposure coupled with proper planning reduces exposure and creates value. This article introduces key questions that can stimulate learning and lead to actionable steps. Explore how this applies to your company!

Click here to read the article posted in The Daily Pitch: Deal Makers Column or read the first part in this SMEs series, How Baby Boomers' Retirement will Impact Small Businesses.

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