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Transfer Pricing: Navigating the Perfect Storm

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A "perfect storm" of significant events have come together the past several years to materially increase the transfer pricing risks and related documentation burdens for multinational companies with international cross-border transactions. This is the advice and perspective of Doug Wright, BPM’s Partner-in-Charge of International Tax and Transfer Pricing Services.

“Transfer pricing” refers to the intercompany pricing arrangements for transfers of tangible and intangible property, services, and financial transactions among related entities within a corporate group. It is a major issue for multinational companies and the tax authorities that monitor them due to the opportunity to shift profits among the entities. Major accounting firms have reported that transfer pricing is the single most significant issue facing the corporate tax function.

Each year, additional countries attempt to "out-do" each other by adopting ever more stringent transfer pricing rules, almost always including detailed annual contemporaneous documentation requirements and onerous penalty provisions intended to encourage taxpayer compliance and facilitate audit by the tax authorities. Many countries, including the U.S., have made no secret of their plans to substantially increase their tax audit staffs with specially-trained international examiners and economists devoted to transfer pricing issues.

As if the “traditional” tax audit process was not sufficient to identify potential transfer pricing issues, the U.S. and many foreign jurisdictions have also enacted specific provisions requiring detailed disclosures either directly on the tax return or in statutory financial statements of intercompany transactions and related transfer pricing terms. The U.S. effectively accomplished these objectives with the implementation of Financial Accounting Standards Board Interpretation No. 48 (“FIN 48”), which requires the disclosure of material “uncertain” tax positions, including transfer pricing matters, in audited financial statements.

In a transfer pricing “perfect storm,” the global economic crisis has now caused tax authorities around the world to more vigorously pursue transfer pricing audits as a ready source of additional revenue at the same time as multinational companies are struggling to survive with reduced staff and budgets to address their increasing transfer pricing compliance burdens. Some traditional low-tax jurisdictions, such as Hong Kong, have increased transfer pricing audits to insure receipt of their share of multinational tax revenues. Even India, which offers a variety of tax holidays, has aggressively pursued transfer pricing audits for companies with tax holidays, since income resulting from transfer pricing adjustments is not covered by India's tax holiday regimes.

Transfer pricing adjustments made during a U.S. or foreign country tax audit can also have an adverse “cascading” effect when income is effectively shifted from one taxing jurisdiction to another. In such situations, it is not always possible for a taxpayer to make a correlative adjustment to decrease income in the other taxing jurisdiction. This increases the potential for double taxation of the same income. Even if a correlative adjustment can be made, other international tax planning and compliance may go awry due to the need to make such an adjustment.

As a final bit of transfer pricing “turbulence,” those multinational companies that have previously evaluated and properly documented their intercompany transfer pricing arrangements may, nonetheless, find that the current economic situation has frustrated the critical economic assumptions underlying those arrangements. For example, members of a multinational group that have historically shown significant profits may now be thrown into a loss, while members with limited economic risks that have been compensated on a “cost-plus” basis may now be earning a disproportionate share of the group’s worldwide profits. Comparable unrelated companies that may have been used to “benchmark” the arm’s length terms for intercompany transactions may have even disappeared during the current economic crisis.

In order to navigate the transfer pricing “perfect storm,” multinational companies need to carefully review their current intercompany activities and operations; evaluate the sufficiency of their existing transfer pricing documentation, including any prior year transfer pricing analyses or studies; identify the need for updated or revised documentation to reflect changes in activities, operations, or underlying economic assumptions; and, particularly for those companies with audited financial statements, review their efforts and results with their auditor. Of course, timely involvement of a transfer pricing specialist can prove invaluable in these matters.

A summary step-by-step plan for navigating the transfer pricing “perfect storm” would include:

1. Develop a detailed inventory of all cross-border intercompany transactions, including those involving transfers of tangible or intangible property, intercompany services (including headquarters management or “back-office” support), and financing arrangements.

2. Collect and review the sufficiency of existing transfer pricing documentation for each set of intercompany transactions, including:

- Intercompany and intra-company agreements and pricing arrangements;

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- Invoices fully describing the details and transfer pricing terms of the transactions;
- Books and records accurately reflecting and supporting the terms of the transactions; and d. Prior or current year transfer pricing analyses or studies.

3. In the case of material intercompany transactions, perform or update a functional analysis that identifies and documents the current intercompany functions performed, assets employed, and economic risks assumed by each party. Such an analysis is a virtually uniform requirement of transfer pricing laws and regulations around the globe.

4. With the results of the functional analyses in hand, perform and document appropriate economic analyses applying the specific methodologies required under the relevant U.S. and foreign country transfer pricing rules. These economic analyses can rarely be completed by the taxpayer acting alone, since they inevitably require the use and specialized analysis of proprietary transfer pricing databases.

5. In the case of transfer pricing arrangements that are based on the allocation of costs or that provide for cost-plus intercompany charges (particularly for intercompany services), evaluate the cost base to ensure inclusion of all relevant allocable costs. In addition, examine whether or not the corresponding economic benefit to the receiving party has been adequately described in the intercompany agreements and invoices to support acceptance of the allocated costs and any markups thereon by local tax authorities.

The challenge for multinational companies navigating these waters is to generate sufficient awareness and resources within the company to execute these steps. For most companies, this will require the potential involvement of various departments, both within and without the U.S., including logistics, research and development, manufacturing, sales, intangible property licensing, treasury, finance and senior management. Ultimately, the company will have to determine, evaluate, and prioritize the areas of potential transfer pricing risk in consultation with its outside auditors. For calendar year companies, the time to begin this process is now, so that any changes, improvements, or additional documentation required can be developed before year end.

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BPM's International Tax Services practice includes a dedicated team of experienced transfer pricing specialists who can work with clients to ensure compliance with the increasingly rigorous global transfer pricing rules and documentation requirements. BPM's transfer pricing specialists are also available to assist in implementing any changes to a client's current intercompany transfer pricing arrangements or documentation, should current economic conditions create issues or opportunities for improvement of existing transfer pricing policies or results.

Doug Wright, BPM's Partner-in-Charge of International Tax and Transfer Pricing Services, joined BPM in November 2008. For more than 25 years Doug has specialized in international tax and transfer pricing planning, consulting and compliance for both public and private companies in all major industries.

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