TRANSFER PRICING

DOCUMENTATION, CONSULTING AND ARMS-LENGTH PRICE DETERMINATION

Transforming global problems into global solutions

TRANSFER PRICING is a term used to describe all aspects of intercompany pricing arrangements between related business entities, and commonly applies to intercompany transfers of tangible and intangible property. Intercompany transactions across borders are growing rapidly and are becoming much more complex.

Any time related parties on different sides of international borders conduct business, the Taxing authorities from both countries will insist on taxing their fair share of the income. The IRS will scrutinize the cost regardless of whether it is either a U.S. subsidiary of a foreign parent or a U.S. parent of a foreign subsidiary.

THE "ARMS-LENGTH" PRINCIPLE

The "arms-length" standard has been the benchmark in determining transfer prices for intercompany transactions since the IRS issued regulations under a predecessor to Section 482 in 1935 and pursuant to this standard, the appropriate transfer price of a transaction between two related parties is that price or range of prices that would have been bargained for and agreed upon but for the fact that the related parties had not been related and accordingly deemed "uncontrolled", and is essentially a fair market value standard that requires parties to make hypothetical determinations that are fact dependent, judgmental, and subjective in nature, thus the room for controversy.

- Global integration and new business practices challenge multinational corporations to find innovative transfer pricing solutions.
- Stricter penalties, new documentation requirements, increased information exchange, improved training and specialization are some of the tools used by tax authorities in this global "revenue race."

In order to comply with transfer pricing rules worldwide, our Transfer Pricing Team will work with you to develop an overall comprehensive tax planning strategy.

TRANSFER PRICING DOCUMENTATION

An increasing number of countries now impose transfer pricing documentation requirements, most of which can be onerous for affected businesses. Using finely tuned methods to efficiently document transfer pricing policies, dedicated specialists—including economists and tax professionals—can provide an integrated, multi-country approach to meeting documentation obligations

The DECOSIMO Global Transfer Pricing Team, comprised of dedicated transfer pricing specialists with advanced training in economics, accounting, project management and law, will work with you to develop a strategy to meet your global business goals and objectives.

Our combined experience enables us to develop innovative approaches for an expansive list of clients, from high growth entrepreneurs to established market leaders, in a wide range of industries. Through our expertise, we have created a set of transfer pricing services to assist you in achieving your strategic global business objectives.

Transfer Pricing Clients with foreign affiliates who enter into transactions for goods and services with each other are subject to transfer pricing rules. The rules require that companies adequately document the pricing policies of their inter-company transactions. The rules also stipulate how arm's length prices should be established. Clients who do not abide by applicable transfer pricing laws are subject to additional taxes and possible severe penalties. (Canada for example is taking an extremely aggressive position to enforce their transfer pricing laws).

U.S. INTERCOMPANY TRANSFER PRICING RULES:

The Code and underlying regulations are based on the principle that transactions between related parties should be evaluated on an arm's-length basis, i.e., how unrelated parties would structure a transaction in an uncontrolled situation. This principle creates transfer pricing issues when one of the related parties is offshore.

The arm's-length character of a transaction between related parties is best tested by comparing the results of the transaction in question with the results of unrelated taxpayers engaged in comparable transactions under comparable circumstances. The use of comparables is important in all of the arm's-length transfer pricing methods described below. Comparability of transactions to test the arm's-length nature of a related-party transfer price is established by looking at the following factors specified in Reg. 1.482-1(d):

- Functions performed
- Risks assumed
- Contractual terms
- Economic conditions
- The nature of the property or services

Based on the above list, for two transactions to be comparable, parties should perform the same functions (e.g., research and development, product design, assembly, marketing, administration, transportation, and warehousing) with respect to the transactions. Also, risks borne by the parties to each transaction should be similar (e.g., market risks, research risks, financial risks, credit and collection risks, and general business risks).

With respect to the comparability of contractual terms (e.g., quantity, duration, and warranty), these provisions for the related and unrelated transactions should be comparable. Finally, for purposes of comparison, the economic conditions surrounding the two transactions (e.g., market alternatives, geographic market similarities, size, and composition) should be similar.

These related-party transfer pricing rules apply to the following types of transactions:

- Sales of products
- Licenses
- Services
- Debt
- Leases

PROPERTY TRANSFER PRICE METHODS

The appropriate transfer pricing methods depend on the types of transactions engaged in by the related parties. The methods available for pricing products (i.e., tangible property) and licenses (i.e., intangible property) are listed below.

TANGIBLE PROPERTY:

- Comparable uncontrolled price method (CUP)
- Resale price method (RPM)
- Cost plus method (C+)
- Comparable profits method (CPM)
- Residual profit split method (RPSM)
- Comparable profit split method (CPSM)
- Other unspecified methods

INTANGIBLE PROPERTY:

- Comparable uncontrolled transactions method (CUT)
- Comparable profits method (CPM)
- Residual profit split method (RPSM)
- Comparable profit split method (CPSM)
- Other unspecified methods

Under the comparable uncontrolled price method (CUP), the transfer price for tax purposes is based on uncontrolled sales made by one of the related parties to unrelated buyers. If the CUP method is unavailable (e.g., for lack of comparables), the resale price method (RPM) may be the best method to determine an arm's-length price, particularly if the related purchaser does not add significant value to the product. The RPM is intended to measure the value of the distribution function performed by a related purchaser.

The cost plus method (C+) is most appropriate when comparable unrelated sales are lacking and the related purchaser does more than mere distribution, e.g., the subsidiary adds substantial value to the prod-

uct, or uses significant intangibles. Under this method, the costs of the company selling to the related party are determined, and an appropriate gross profit markup is applied to determine the deemed sales price paid by the related party.

The comparable profits method (CPM) is based on the principle that similarly situated taxpayers will tend to earn similar returns over a reasonable period of time. The CPM determines arm's-length consideration for the controlled transfer of property by referring to objective measures of profitability (profit level indicators, i.e., financial ratios) derived from uncontrolled taxpayers that engage in similar activities with other uncontrolled taxpayers. An arm's-length range of constructive operating profits is determined by applying the financial ratios to the related party. Thus, this process involves the analysis of financial statements of unrelated third parties, the construction of proper financial statement ratios, and the superimposition of those results on the transactions between the two related parties in question.

Under the comparable profit split method (CPSM), the combined operating profit of the controlled shareholders is allocated among them in the proportions derived from the combined operating profit of uncontrolled taxpayers whose transactions and activities are similar.

The residual profit split method (RPS), is generally used when one of the related parties owns a significant portion of the intangible assets, and thus the overall profit is split between the related parties based on the functions performed by the related party not owning the intangible assets, with the residual profit allocated to the other related party.

Transfer pricing for licensing intangible assets follows similar methods to those for the transfer pricing of products indicated above. The transfer pricing regulations regarding whether the party financing generally benchmarks the interest charge based on market forces in the local jurisdictions, and the transfer pricing for related-party management services is based on an analysis of the direct and indirect costs incurred to render such services.

SERVICES

New IRS Proposed TRANSFER PRICING SERVICES REGULATIONS issued in October 2003 seem to sensibly address inefficiencies in the existing regulatory framework and arrive at understandable results, but the well-established line between intercompany services transactions and actual transfers of intangible property is blurred as a result.

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TYPICAL CLIENT BENEFITING FROM TRANSFER PRICING:

Is a domestic corporation (whether or not ultimately US-owned); and has international cross-border transactions (involving tangible personal property, royalties, or services) with related parties, where the US is one of the countries involved;

- Has 2 or more foreign affiliates (e.g., branch, CFC, joint venture, partnership); and/or
- Is a domestic corporation that is the ultimate parent of a controlled/consolidated/affiliated group; and/or
- Is a domestic corporation that is ultimately foreign owned; and/or
- Has thousands of international cross-border transactions with related parties (generally, the more the better); and/or
- Has a small or non-existent international tax staff or department; and/or
- Is not a subsidiary of a US controlled/consolidated/affiliated group.

DECOSIMO'S TRANSFER PRICING STUDIES develop coordinated global transfer pricing documentation and defense files that are consistent with a multinational company's needs in multiple jurisdictions. Taxpayers have historically used a country-by-country approach involving stand alone projects in multiple countries. This frequently results in duplication of data collection efforts and transfer pricing reports that are inconsistent with the global needs of the company.

Such a project involves the preparation of a "core" document package that is used by each country in the efficient preparation of separate country reports that satisfy each country's specific requirements. The philosophy of the core documentation is to collect common data and background information that can be shared among the countries requiring documentation, thus avoiding duplicate collection efforts and ensuring a coordinated approach to the analysis.

Most countries' transfer pricing documentation requirements include a functional analysis, an economic analysis, a financial analysis, and the selection of the most appropriate transfer pricing methodology. The specific application of these steps will vary by country, but the shared characteristics of each step provide the opportunity for streamlining the documentation process. The responsibility for each country's report is in the hands of the local Transfer Pricing Partner, but the process is coordinated globally to ensure consistency and accuracy in factual disclosure.