

State transfer pricing—Preparing for increased scrutiny of intercompany transactions

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Overview: What is transfer pricing?

- Transfer pricing (TP) refers to the pricing used in intercompany transactions within a group of controlled taxpayers
- TP affects the allocation of the total profit among related taxpayers
- Key driver for global tax rate
- Critical to global cash and tax management strategy
- Multitude of multistate and local country tax and indirect tax considerations
- Tax authorities can make transfer pricing adjustments even if the taxpayer did not intend to inappropriately shift income through transfer pricing

IRC § 482

In any case of **two or more organizations**, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the **Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations**, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order **to prevent evasion of taxes or clearly to reflect the income** of any of such organizations, trades, or businesses. In the case of any transfer (or license) of intangible property (within the meaning of section 936 (h)(3)(B)), the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible.

IRC § 482 regulations

- Key components of the final IRC §482 regulations are as follows:
 - *Arm's-length principle*—results of the transaction are consistent with the results that would have been realized if uncontrolled taxpayers had engaged in the same transaction under the same circumstances.
 - *Best method rule*—a method that provides the most reliable measure of an arm's-length result.
 - *Comparability*—specific factors should be considered when determining comparability.
- IRC § 482 is not self-executing. It provides the IRS discretion to make adjustments.

Overview: Examples of intercompany transactions

Tangible property transactions

- Sale of tangible products for distribution to customers

Intangible property transactions

- Licensing of intellectual property (includes patents, know-how, trade secrets, etc.)

Services

- Management services
- Technical services (e.g., IT support, sales support, etc.)
- Sales and marketing services

Financial Arrangements

- Loans/guarantee fees/cash pooling

Cost sharing arrangements

- More than one affiliate in the group contributes resources to a common goal, such as to develop intangibles.

Transfer pricing analysis (key elements)

- Reviewing intercompany agreements and course of conduct to accurately delineate the intercompany transactions
- Determining the relative functions performed, risks assumed and assets employed by the respective related taxpayers
- Selecting the best method to test the results of the intercompany transactions
- Reviewing comparables to calculate an arm's length range of results
- Comparing the taxpayers' actual results to calculated arm's length range

US Transfer pricing documentation

Treas. Reg. § 1.6662-6

- A report that analyzes related party transactions during the just completed tax year.
- Provides protection against transfer pricing adjustment penalties.
 - Must satisfy reasonable basis standard.
 - Note that this is a different level of authority than is required by some states.
 - Must contain the 10 principal documents. (see Treas. Reg. 1.6662-6(d)(2)(iii)(B))
 - Must be completed in draft form contemporaneously with tax return (does not get filed with tax return), AND be provided to IRS within 30 days of request.
- Components of a documentation report
 - Statement of facts—describes the taxpayers' activities and relevant related party transactions.
 - Economic analysis.
 - Results of the economic analysis are compared to actual intercompany prices to show that they were at arm's-length.

Common TP audit issues

Federal

- Character of related parties (entrepreneur vs. routine functions, conduct vs. contracts)
- Royalties (lack of benefit, value compared to local contributions)
- Service charges (benefit, cost base, pass-through costs, stock-based compensation, and markups)
- Tangible goods (embedded royalties, bundled transactions)
- Recurring local losses treated as a service to the global group

Transfer pricing: Current state tax environment

State adoption/conformity to IRC § 482

States may seek to impose IRS § 482-type powers in the following ways:

- Adopting the IRC by reference, including § 482
- Adopting federal taxable income as the starting point in determining state taxable income
- Adopting statutes analogous to IRC § 482
- Commissioner's discretion
- UDITPA provides rules regarding the allocation and apportionment of income among states

State authority—intercompany transactions

State statutes typically use one of the following ways to address intercompany transactions:

- Disallowance of deductions for specific payments made to related parties (the add-back rules)
- Changing the value of transactions between related parties (IRC § 482 principles) and treating adjustments as transfers
- Forced combination or consolidated filing including tax haven countries
- Asserting jurisdiction over a non-filing entity based on the related party attributes in the state (i.e., “Geoffrey” nexus)
- Applying economic substance, business purpose, or sham transaction doctrines (striking down the arrangement)

Recent state tax authority audits

State audits of intercompany transactions

- Audits are generally tougher and take longer
 - Fact intensive IDRs
- More aggressive audit assessments and increased litigation
- Increased focus on transfer pricing and related documentation
 - Jurisdictions have engaged third-party specialists
 - Court filings in District of Columbia
- Increased focus on economic substance/business purpose
- Royalty and interest transactions closely scrutinized

Recent state tax authority audits (cont.)

Supply-chain based structures

- Should have substance and be supported by business purpose
- Generally not subject to add back
 - Flows of tangible property
- States forcing select combined filing
- Attacks are increasingly based on pricing

Focus on embedded royalties

- Difficult to identify and isolate
- Structural challenges

Practical considerations

Implementing the structure

Have written agreements.

- They should be as detailed as an agreement with an unrelated party would be.
- The agreement should provide for actual payments for goods and services, not just for bookkeeping entries.
- The term should be consistent with commercial custom.
- Accounting records should support the financial structure of the transaction.

Practical considerations

Management services agreements

- Agreements should be detailed and spell out all the services to be provided.
- Fee is typically based on cost plus a profit mark-up (e.g., between 5 percent and 10 percent).
- Allocating the fee among service recipients.
- Impractical to base it on value of services provided to each company.
- Allocations based on gross revenues or gross profits are generally OK. Allocations based on net income are not.

Practical considerations

Administering financial arrangements—loans/cash management

- Execute loan documents
- Must contain third party formalities—default and enforcement provisions
- Fixed interest rate/principal/maturity date
- Performance
- Timely payments that are consistent with the note
- Financial records support the repayment of the loan
- Ledger/bank statements
- Cash transfers
- Debt/equity analysis
- Federal and state case law
- Can the debtor repay the loan
 - Cash flow
 - Earnings
 - How would a bank or credit agency rate the debt

Practical considerations

Administering transfer pricing arrangements

- Provide a memorandum to the business people at the outset.
- Company personnel may follow the rules at the start but may be less conscientious as time passes. Tax personnel should monitor compliance on a regular, periodic basis.
- Payments should be made when due. Goods and services should be provided timely and efficiently.
- Evaluate the fairness of the pricing periodically.

Practical considerations

Audits and controversies

- Emphasize and document business reasons for the arrangement.
- If the corporate parties to the arrangement are different profit centers for purposes of internal accounting and employee compensation, this should be emphasized.
- If you have good documentation, produce it early in the process.
- Use your experts early in the process. Don't rely on general statements about compliance with arms-length standards.
- If an auditor disallows a transfer pricing transaction, request a written explanation of the denial.

Practical considerations

Retaining a consultant

- It is generally acceptable to use a company that has a prior relationship with the taxpayer. Its professionals understand the company's business.
- Use an individual who would be a good expert witness.
- Retain a consultant when the arrangement is being established for the purpose of advising on what the pricing should be. Do not wait until the tax audit.
- Negotiate the engagement letter.

Practical considerations

Retaining a consultant

Should the consultant be retained by an attorney to bring its work within the attorney-client privilege (i.e., a Kovel arrangement)?

- Not if retention is to aid company in pricing sales. The privilege is available only if the retention is to help the attorneys give legal advice.
- Perhaps, if the retention is in connection with a tax audit.
- Review report carefully. Make corrections.

Things to watch out for:

- Facts should be accurate.
- Purpose should be stated (e.g., to assist the company in pricing transactions).
- Comparables should really be comparable.
- Excessive boilerplate language is generally bad (as are too many references to the 482 regulations).

OECD BEPS Initiative

- **Base Erosion and Profit Shifting (BEPS)** refers to tax planning strategies that supposedly exploit gaps and mismatches in tax rules to artificially shift profits to low or no-tax locations where there is little or no economic activity, resulting in little or no overall corporate tax being paid.
- Organisation for Economic Co-operation and Development (OECD) estimates annual losses of anywhere from 4-10 percent of global corporate income tax revenues, i.e., \$100 billion to \$240 billion annually.
- Per the OECD: “Fifteen actions equip governments with the domestic and international instruments needed to tackle BEPS. The final BEPS package gives countries the tools they need to ensure that profits are taxed where economic activities generating the profits are performed and where value is created, while at the same time give business greater certainty by reducing disputes over the application of international tax rules, and standardising compliance requirements.”

BEPS Action items—TP impact

(Actions in bold are relevant to TP)

Action 1—Address the Tax Challenges of the Digital Economy

Action 2—Neutralise the Effects of Hybrid Mismatch Arrangements

Action 3—Strengthen CFC Rules

Action 4—Limit Base Erosion via Interest Deductions and Other Financial Payments

Action 5—Counter Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance

Action 6—Prevent Treaty Abuse

Action 7—Prevent the Artificial Avoidance of PE Status

Actions 8-10—Assure that Transfer Pricing Outcomes are in Line with Value Creation

Action 11—Measuring and Monitoring BEPS

Action 12—Require Taxpayers to Disclose their Aggressive Tax Planning Arrangements

Action 13—Re-examine Transfer Pricing Documentation

Action 14—Make Dispute Resolution Mechanisms More Effective

Action 15—Develop a Multilateral Instrument

Country-by-Country reporting

Annex III to Chapter V

A model template for the Country-by-Country Report

Table 1. Overview of allocation of income, taxes and business activities by tax jurisdiction

Name of the MNE group: Fiscal year concerned:										
Tax Jurisdiction	Revenues			Profit (Loss) Before Income Tax	Income Tax Paid (on cash basis)	Income Tax Accrued – Current Year	Stated capital	Accumulated earnings	Number of Employees	Tangible Assets other than Cash and Cash Equivalents
	Unrelated Party	Related Party	Total							

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Country-by-Country reporting

Table 2. List of all the Constituent Entities of the MNE group included in each aggregation per tax jurisdiction

Name of the MNE group: Fiscal year concerned:														
Tax Jurisdiction	Constituent Entities resident in the Tax Jurisdiction	Tax Jurisdiction of organisation or incorporation if different from Tax Jurisdiction of Residence	Main business activity(ies)											
			Research and Development	Holding or Managing intellectual property	Purchasing or Procurement	Manufacturing or Production	Sales, Marketing or Distribution	Administrative, Management or Support Services	Provision of Services to unrelated parties	Internal Group Finance	Regulated Financial Services	Insurance	Holding shares or other equity instruments	Dormant
	1.													
	2.													
	3.													
	1.													
	2.													
	3.													

² Please specify the nature of the activity of the Constituent Entity in the “Additional Information” section.

Multistate Tax Commission

Arm's-Length Adjustment Service (ALAS)

- Participating states: AL, IA, KY, NJ, NC, PA
 - Program not ratified at MTC annual meeting
 - MTC continues to encourage other states to participate
- Potential exists for state revenue agencies to be supported by external economic consulting firms in the following areas:
 - Training
 - Audit selection
 - Economic analysis
 - Litigation support
- Some states may find alternative solutions

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