

# Transfer Pricing – The Arm's Length Standard & Its Role In Global Trade and Finance



HLB North American Tax Conference  
San Juan, Puerto Rico  
Monday, December 5, 2011

Mark Madrian – Ceteris Salt Lake City/Los Angeles  
Bryan Ross – Eide Bailly LLP, Minneapolis, MN



CPAs & BUSINESS ADVISORS



# What Is Transfer Pricing?

**Legal Principle: Related parties engaged in cross-border transactions should deal with each other as if they were unrelated entities**

- **Intercompany pricing (tangible goods, services, IP licensing, financing) should reflect arm's length relationships: What would an unrelated party have paid for the same/comparable product, service or loan?**
  - Can a taxpayer point to similar transactions (i.e., terms and conditions) in the broader market?
  - Does the transaction have a clear business purpose (other than tax avoidance)?
  - Do the financial terms meet the Commensurate with Income standard?

**Regulatory Framework: Organization for Economic Cooperation and Development (OECD) has issued transfer pricing guidelines**

- **OECD Framework** – More than 50 countries (including the U.S.) have adopted the general framework in the OECD transfer pricing guidelines
- **Local Country Rules** – Many countries (include those that follow the OECD framework) have issues transfer pricing regulations with country-specific requirements
  - U.S. guidelines found in two sections of the Treasury Regulations – Section 482 (transfer pricing guidelines) and Section 6662 (penalty and documentation guidelines)
- **Enforcement Activities** – This varies from country-to-country; however, the trend continues to be stricter and more aggressive enforcement across nearly every jurisdiction



# Typical Intercompany Transactions

---

- **Sales of Tangible Property**

- Automobile components manufactured in Japan and transferred to U.S. affiliate for final assembly
- Agricultural products grown, harvested, processed and packaged in the U.S. and transferred to Chinese affiliate for final distribution

- **License of Intangible Property**

- U.S. technology company licenses patents and know-how to its Irish manufacturing subsidiary
- Consumer products company grants distribution rights (e.g., customer lists, trademark) to Canadian subsidiary

- **Performance of Services**

- U.S. parent company performs administrative services for all non-U.S. subsidiaries
- Indian subsidiary performs software development and maintenance services for U.S. parent

- **Intercompany Loans & Guarantees**

- U.S. parent provides loan guarantee to U.K. subsidiary seeking to obtain a line of credit for working capital needs
- U.S. parent loans funds to Singapore subsidiary to expend manufacturing facilities



# Intercompany FX Transactions & Transfer Pricing

- **Transfer Pricing's Focus**
  - **Functions – What activities (e.g., distribution, manufacturing, administrative, finance, etc.) do the related parties perform?**
    - Global treasury function (e.g., FX hedging) is a covered function under the U.S. Transfer Pricing Service Regulations
  - **Risks – What risks (e.g., receivables, foreign exchange, inventory, product warranty) do the related parties assume or manage?**
    - FX and hedging risk is a key focus area when assessing a taxpayer's global operations – do these risks require additional profit to compensate the risk taker
  - **Assets – What assets (e.g., tangible, real estate or intangible) do the related parties own?**
    - Hedging contracts and similar financial instruments are considered in the intercompany pricing analysis
  - **Shifting functions, risks and assets between related parties to arrive at optimal tax structure**
    - Moving the risks (e.g., FX risks) or functions (e.g., centralizing high-value financing function) between high- and low-tax jurisdictions



# Intercompany Loans

- **Intercompany Loans**
  - **U.S. transfer pricing rules include *Safe Harbor* or arm's length rate**
    - Safe Harbor relies on Applicable Federal Rate (AFR) that can be applied to U.S. dollar denominated loans
    - AFR rates are not viewed as arm's length from a non-U.S. perspective –AFR rates are relatively lower than market rates. AFR range may be an unreliable indicator of arm's length dealings during an economic downturn (e.g., Treasury rates were declining while credit spreads for corporate borrowers were expanding)
  - **U.S. transfer pricing rules do not specify method to determine arm's length interest rate**
    - Rate should equal what would have been charged in independent transactions with unrelated parties under similar circumstances
    - Consider the following factors: Principal amount; duration; borrower's credit rating (can calculate a credit rating using models like Moody's RiskCalc); subordination of loan; fixed vs. floating rates; currency; prepayment provisions; and market interest rates



# Intercompany Guarantees

- **Intercompany Guarantees**
  - **Guarantees enable a company to borrow at a lower rate**
    - Parent company guarantees a credit line for a foreign affiliate to reduce borrowing costs
    - Difference in interest rate (i.e., stand alone rate less the actual rate sets an upper bound for the guarantee fee)
  - **U.S. transfer pricing rules do not provide much guidance on methods or approaches to price a guarantee**
    - Estimate the amount and cost of additional equity capital that a company would have to contribute to the borrower to mimic the impact of a guarantee



# Current Environment

- **Obama Administration & Congress Focus On Safeguarding & Expanding Revenue Base**
  - **Expanding definition of intangible property to capture related tax revenues**
    - Expand definition to include goodwill, going concern value and workforce in-place
  - **Tax excessive returns associated with IP transfers from the U.S. to low tax jurisdictions**
    - Proposed baseline: 10 percent or less as low effective tax rate; 30 percent or more as an excessive return given the low tax rate
  - **Adding international examiners and using outside experts to examine transfer pricing issues**
  - **Increased audit activity and litigation related to transfer pricing matters**
    - Small and medium sized business are reporting increased audit activity in the US and abroad (particularly in Canada and Mexico)
    - Other CPA firms are seeing a substantial increase in audit activity related to transfer pricing at small/middle-market companies



# Best Practices

- **Align Transfer Pricing Policies with Operational Realities**
- **Adopt a Global Approach to Transfer Pricing Strategy – Look at Both Sides of the Transaction(s)**
- **Conduct an Annual Assessment of All Intercompany Transactions: Examine Volume; Transaction Type; Dollar Amount; Regulatory Requirements; and Audit History – Develop Risk/Compliance Matrix**
- **Reconcile Valuation Reports (e.g., Purchase Allocation Studies) with Transfer Pricing Strategy/Results**
- **Develop and Execute an On-going Transfer Pricing Compliance Strategy**
- **For Public Companies, Evaluate Global and Local Transfer Pricing Policies in Conjunction with FIN 48 Compliance Efforts**