Transfer Pricing – Past, Current and Future

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Agenda

– Overview
– IRC §482
– Common Examples of Intercompany Transactions
– Transfer Pricing Analysis
– Documentation and Audit Issues
– Transfer Pricing in the Current State Environment
– Practical Considerations
– OECD and Base Erosion and Profit Shifting (“BEPS”) Initiative
– Multistate Tax Commission: Arm’s-Length Adjustment Services
Overview: What is Transfer Pricing?

- Generally - transfer pricing refers to the charges used in intercompany transactions within a group of controlled taxpayers.
- Transfer pricing often affects the allocation of the total profit among related taxpayers.
- Transfer pricing arrangements can be a key driver for global tax rate.
- Critical to global cash, performance & 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.
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 Section 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.
Common Examples of Intercompany Transactions

- Tangible property transactions
  - Sale of tangible products for ultimate distribution to customers
- Intangible property transactions
  - Licensing of intellectual property (includes patents, know-how, trademarks, trade secrets, etc.)
- Services
  - Management, legal, accounting, tax, treasury and other 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 identify and isolate intercompany transactions
  - This can be time consuming
  - Documentation is key
- 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
  - Documenting rejected comparables can be meaningful
- Comparing the taxpayers’ actual results to calculated arm’s length range
  - Monitor results, evaluate arrangements at meaningful intervals
US Transfer Pricing Documentation – Treas. Reg. §1.6662-6

- A report that analyzes related party transactions during the just-completed tax year
- Compliance 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 Transfer Pricing (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
Transfer Pricing:
Current State Tax Environment
State adoption/conformity to IRC §482

States may seek to impose IRS §482-like powers in several ways:

- Adopting the Internal Revenue Code 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 utilize one of the following to challenge intercompany transactions:

• Disallowance of deductions for specific payments made to related parties (the “add-back” rules)
• Changing the value of transactions between related parties (applying 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)
State audits of intercompany transactions

- Audits are generally complex and take longer
  - Fact intensive IDRs
  - Be certain that business units are not responding to these queries
- 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, debt and interest transactions closely scrutinized
Supply-chain based structures
• Should have substance and be supported by business purpose
• Generally not subject to add back
  − Flows of tangible property
• States can compel a combined filing where authority supports it
• Attacks are increasingly based on economics and pricing

Focus on embedded royalties
• There is some chatter at the state level that this is going to be an area of focus.
• Difficult to identify and isolate
• Structural challenges
Practical Considerations: Implementing the Structure

Have written agreements for each product/service provided
  • 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 accounting entries.
  • The terms should be consistent with current economics and commercial customs.
  • Accounting records should support the financial structure of the transactions.
  • Store agreements in permanent binders or corporate minute books when appropriate.
Practical Considerations: Management Services Agreements

• Agreements should be detailed and spell out all the services to be provided.

• Fee is often based on cost plus mark-up (e.g., between 5% and 10%).

• Allocating the fee among service recipients is common.
  – Impractical to base the allocation on value of services provided to each company.
  – Allocations based on gross revenues or gross profits are generally acceptable.
Practical Considerations: Administering Financial Arrangements – Loans / Cash Management

– Execute loan documents
  • Must contain third party formalities – default & enforcement provisions
  • Fixed interest rate / principal / maturity date

– Performance
  • Timely payments that are consistent with the terms of the notes

– Financial records support the repayment of the loan
  • Ledger / bank statements
  • Cash transfers

– Debt / equity analysis
  • Federal & state case law
  • Can the debtor repay the loan?
    – Cash flow & Earnings
    – How would an unrelated bank or credit agency rate or negotiate the debt?
Practical Considerations: Administering Transfer Pricing Arrangements

– Provide instructions and guidance to the business unit early in the process.
– Tax personnel should monitor compliance on a regular, periodic basis.
  • Company personnel may follow the rules in the early stages but may be less conscientious as time passes and turnover occurs.
– Payments should be made timely.
– 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, these facts should be emphasized.

– If you have good documentation, produce it early in the process.
  • After all – this is why you produced it.

– Use your experts early in the process. Don’t rely on general statements about compliance with arm's-length standards.
  • Adequately prepare business personnel for interviews.

– If an auditor disallows a transfer pricing transaction, request a written detailed explanation of the denial.
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% 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
### 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**

<table>
<thead>
<tr>
<th>Tax Jurisdiction</th>
<th>Unrelated Party</th>
<th>Related Party</th>
<th>Total</th>
<th>Profit (Loss) Before Income Tax</th>
<th>Income Tax Paid (on cash basis)</th>
<th>Income Tax Accrued - Current Year</th>
<th>Stated capital</th>
<th>Accumulated earnings</th>
<th>Number of Employees</th>
<th>Tangible Assets other than Cash and Cash Equivalents</th>
</tr>
</thead>
<tbody>
<tr>
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</tr>
</tbody>
</table>


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

<table>
<thead>
<tr>
<th>Tax Jurisdiction</th>
<th>Constituent Entities resident in the Tax Jurisdiction</th>
<th>Tax Jurisdiction of organisation or incorporation if different from Tax Jurisdiction of Residence</th>
<th>Main business activity(ies)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td>Research and Development</td>
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<td>Holding or Managing</td>
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<td></td>
<td></td>
<td></td>
<td>Intellectual Property</td>
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<td></td>
<td></td>
<td></td>
<td>Purchasing or Procurement</td>
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<td></td>
<td></td>
<td></td>
<td>Manufacturing or Production</td>
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<tr>
<td></td>
<td></td>
<td></td>
<td>Sales, Marketing or Distribution</td>
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<tr>
<td></td>
<td></td>
<td></td>
<td>Administrative, Management, or Support Services</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Provision of Services to unrelated parties</td>
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<tr>
<td></td>
<td></td>
<td></td>
<td>Internal Group Finance</td>
</tr>
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<td></td>
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<td></td>
<td>Regulated Financial Services</td>
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<td></td>
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<td></td>
<td>Insurance</td>
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<td></td>
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<td></td>
<td>Holding shares or other equity instruments</td>
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<td></td>
<td></td>
<td></td>
<td>Dormant</td>
</tr>
<tr>
<td></td>
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<td></td>
<td>Other²</td>
</tr>
</tbody>
</table>

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

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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

• Meeting on April 7
  • Goal to be actively communicating on live cases by July
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