TRANSFER PRICING INTRODUCTION
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Transfer pricing is one of the most important issues in international taxation. It has become high profile, and must be addressed in any intragroup business transaction, regardless of its size, or the size of the companies. Understanding these rules and implementing them correctly can make managing this high profile issue much more cost effective, and low risk. This is a place where early action can pay huge returns.

We are frequently asked, “What is transfer pricing?”; “What does it mean to my company?”.

Here is a primer on transfer pricing.

What is transfer pricing?

Increased globalization has driven the growth of intragroup trade. Companies are no longer a conglomeration of independent, geographically distinct entities. Companies are now made up of specialized members such as “tollers”, contract manufacturers, distributors, shared service centers, treasury centers, head offices, 4PLs and so on. A significant volume of global trade now consists of transactions between members of multinational enterprise groups. The prices at which an enterprise transfers goods and intangible property or provides services to associated enterprises are transfer prices, i.e. prices that are charged on the transactions between two or more companies that are members of the same group.

The movement of goods and services within the global group is often referred to as the “value chain”. The primary purpose of transfer pricing is to spread the profit on that global value chain to the constituents who contributed to the profit. If done properly, high profits can align to low tax jurisdictions with minimal tax risk and avoidance of double taxation. If not done properly, companies are susceptible to significant tax risk, including double taxation, and penalties that can potentially drive the tax rate up to 100%.

When independent/unrelated enterprises transact with each other, the conditions of their commercial and financial relations (prices, contractual terms, risks, etc.) are usually influenced

by market conditions. When associated enterprises transact with each other, they have the opportunity to optimize the overall tax cost of the group by way of setting prices in a way that would result in a lower tax burden. Therefore, sometimes the prices in intercompany transactions may be manipulated. Consequently, multinational groups, or other parties whose relationships allow them to influence the conditions of the transaction (associated or related parties), may determine their transfer prices in a way that allocates profits to group members in a lower tax jurisdiction, reducing the group's worldwide tax liability.

As far as taxation is concerned, transfer pricing rules exist to provide guidelines on how prices should be set for related party transactions to address potential tax avoidance within a tax jurisdiction or mismatches between profit allocation and the distribution of risks, assets and functions across the group.

For taxation purposes, transfer pricing rules require that the accurate price be established, i.e. the "transfer price", for internal or intragroup transactions and to calculate profits as if the transactions had taken place between independent market players under similar conditions, which is known as the "arm's length" principle. This is an international standard and is used by most tax administrations around the world.

The guiding principle is the "arms length" pricing method.

The "arms length" principle means the related parties must price their intragroup sales, financing and services as if they were unrelated parties. The problem in practice is that very seldom does a related party do business the same way as an unrelated party. For example, a company is generally not inclined to sue itself, so when disputes arise between a buyer and seller in the same international group, it is not resolved in a court room. We also find in intragroup transactions a lower risk of non-payment (although it does happen sometimes under Exchange Control laws). Accordingly, the management of risk in a related party transaction can be significantly different than in a transaction with an independent/unrelated party. So when we apply the "arms length method" to intercompany pricing, we have to adjust it to fit the intragroup risk allocation when factors demonstrate it is different.

The other significant factors are (1) return on asset(s), (2) cost of doing business, (3) brand related premium profit (actually a return on asset analysis), and (4) foreign exchange impact. Regarding the alignment of profit to return on asset(s), it is important to understand that intangible assets can be significant assets for this purpose. There are basically three kinds of intangible assets (1) *product* intellectual property (patents, copyrights, know-how, trade secrets), (2) *brand* and market related intangibles (trademarks, design patents, brand awareness) and (3) *goodwill* (customer relationships, trained workforce, integrated structure). The alignment and ownership of intangible property can also be a key driver of profit alignment in intercompany transactions.

As a consequence, after we adjust the analysis of a related party transaction for the significantly different risk allocation, return on assets and other factors, we find that in a great majority of

cases the method that best fits an intercompany value chain is the "Transactional Net Margin Method" (under the Organization for Economic Cooperation and Development ("OECD") and the "Comparable Profit Margin Method" (under Internal Revenue Code ("IRC") § 482). These are basically the same thing. They measure whether the lowest risk, least complicated company is making a fair profit margin for what it is doing in the value chain. It is therefore not unusual to find a shared service center being compared to Booz Allen Hamilton and DynCorp, because these are firms that do outsourced service work for the government with the following key metrics: low risk of non-payment and, generally, cost-plus pricing.

Adoption of transfer pricing rules

There are international guidelines that most countries follow to some degree or another. They are published by the OECD. These can be found on their website at http://www.oecd.org/tax/transfer-pricing/oecd-transfer-pricing-guidelines-for-multinational-enterprises-and-tax-administrations-20769717.htm

We believe that a number of extra measures should be made to get the organization ready for the increased profile of transfer pricing:

- Articulate and communicate a policy and pricing model
  - Bring in advisors and economists
  - Develop a method that is manageable and can be automated
  - Have a process to adjust pricing as may be required
  - Start with a small work group and expand the stakeholder base as the process develops
- Contemporaneous documentation is vital. Get contracts written and signed. Have invoices prepared as part of the accounting system.
- Have form follow function
- Establish an adequate, comprehensive and precise database, which contains information required for transfer pricing analysis;
- Training the tax authorities' representatives, and exchanging experience with other countries;
- Improve the current IT infrastructure;
- Build pricing on product and sales into the normal day-to-day accounting system(s)
- Align the existing tax returns with the additional requirements for transfer pricing information;
- Prepare additional documentation/paperwork to be completed by taxpayers;
- Communicate with stakeholders on the importance of this new topic and getting it prepared to meet new compliance requirements.

There is a limit to what any country can achieve acting alone. Therefore, international cooperation has a crucial role in the successful implementation of transfer pricing in a particular country, and double tax treaties envisaging the exchange of information should be signed between main trading partners.

Transfer pricing risk management
Under the local legislation of most countries, the tax authorities can conduct "transfer pricing" audits and adjust the prices to determine the fair portion of the income subject to tax. Consequently, it is highly recommended to identify "risky" transactions and assess them in anticipation of such transfer pricing audits.

A lot of people ask, "Do we get protection from a transfer pricing adjustment if we have a Transfer Pricing Report done?". The answer is "No". In the United States, being in compliance with the outcome of a transfer pricing report, prepared on or before the filing of the tax return, can provide you with protection from a negligence penalty of 20%-40%. In other countries, an annual report is required with the tax return(s) (such as, India and Argentina). And, more and more, we find that a transfer pricing report is becoming a standard requirement for financial statutory audits and recurring tax compliance. But, it does not protect you from a tax adjustment for transfer pricing.

It is prudent to consider the allocation of resources by taking a risk-based approach to managing transfer pricing. Here are some specific higher risk transactions and business situations that tend to attract the particular attention of the tax authorities:

- Transactions with related parties in low tax jurisdictions:
  - The tax authorities of most countries have a list of countries that are non-cooperative in the global fight against money laundering and are usually identified as "tax havens" (blacklisted countries);
  - Intragroup services: these include human resources, legal and compliance, controlling and reporting, accounting, tax, IT and other services. The main issue is the ability to provide evidence that services have in fact been rendered, and that the provided services were beneficial for the recipient;
  - Intercompany financing: the principal transfer pricing issue is whether the interest rate charged on the loan has been determined on an arm's length basis;
- Business restructuring:
  - Loss making: sustained losses may be evidence that the reported results have been manipulated and do not reflect the true value;
  - Transfer of intangibles to related parties.

These "risky" transactions may also require more detailed explanations and documentation to be made available, which can protect the taxpayer against many challenges by the tax authorities. This is part of transfer pricing risk identification and assessment processes that are aimed to prevent transfer pricing disputes and prepare the taxpayer for the expected transfer pricing audits conducted by the tax authorities.

Managing the risk

Managing transfer pricing risk has to be a fundamental part of daily business transactions. Contemporaneous documentation and processes built into the group's accounting systems can greatly reduce the cost of managing transfer pricing and the risk of double taxation and penalties. Every company has the ability to seize the high ground and make sure they have the following:

- An articulated policy on transfer pricing;
- A rate card, or pricing chart (for example, wholesale less 10%), or interest model for financing and factoring;
- Up to date intercompany contracts – the foundation of the risk allocation and use of intangible property. These contracts also provide a basis for pricing adjustments that might be necessary to come into compliance with tax rules – e.g., credit and debit memos;
- A quality narrative on the value chain and the pricing used in it. This is something less than a full transfer pricing report in that it does not compare the outcome to a sample of "comparable" companies;
- Proper implementation;
- Monitor results to make sure policy and procedures are working properly. A timely review of your intercompany pricing to confirm it is working as planned (or not) before year end. Typically, companies review their processes ten (10) months into the year enabling them to make necessary corrections during the final two (2) months of the year before the close of the business cycle; and,
- Every three (3) years have a transfer pricing study prepared to make sure you are still within the interquartile of applicable comparables.