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Transfer pricing as an international tax strategy

Compliance studies can lead to planning opportunities

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Transfer pricing involves the terms and prices at which related parties sell (or should sell) goods or services to each other. When the parties are located in different taxing jurisdictions, opportunities exist for the movement of income to a lower-taxing jurisdiction. To combat potential losses of income tax revenue, more than 40 countries have adopted transfer pricing rules and requirements.

Some countries require the completion of transfer pricing documentation to support the taxpayer's reporting position by comparing a company's results to comparably situated unrelated parties. Such an analysis can help a company comply with the documentation requirements and enhance its tax planning. Whether transfer pricing documentation is needed or not, this analysis can uncover possible tax savings or justify price adjustments that may be planned for business reasons.

Nowadays, it's commonplace to observe that American businesses of all sizes are "going global." Their strategies, products and operations are increasingly international in nature and impact. Their manufacturing, distribution and operating facilities are expanding offshore. As companies globalize, however, they can encounter a thicket of tax issues that never entered their field of vision before.

This paper examines one area of international tax - transfer pricing. No longer an obscure concern of a few corporate giants, transfer pricing is now considered to be the most significant international tax issue for executives of multinational companies.

laws generally require companies to demonstrate to taxing authorities that intercompany prices are established on an arm's-length basis. That is, companies need to be prepared to demonstrate that the intercompany prices are in line with what would have been charged had the two companies not been related.

The worldwide growth in transfer pricing regulation is a recent development. In 1994, only the United States and Australia audited transfer pricing aggressively. Since then, more than 40 countries have increased their focus on transfer pricing and begun to more closely monitor and penalize noncomplying transactions.

What is transfer pricing?

Transfer pricing is a strategy adopted by two related companies located in different taxing jurisdictions to exchange products and services between themselves in the most tax-efficient manner possible. The goal of these cross-border transactions is to establish pricing arrangements that minimize taxation and enhance the overall profitability of the parent company. Such arrangements are also often established to eliminate the prospect of double taxation - the possibility of incurring a tax liability in more than one jurisdiction.

Naturally, taxing authorities also want to minimize lost tax revenues, and will scrutinize transfer pricing arrangements closely to ensure they comply with the relevant laws of their respective jurisdictions. Thus, complex transfer pricing tax rules are expanding worldwide. Transfer pricing

How does the IRS treat transfer pricing?

In the United States, the transfer pricing regulations are found in Section 482 of the Internal Revenue Code. Section 482 sets forth the requirements of the arm's-length standard described above. In administering this standard, the IRS has adopted a complex set of regulations that tighten transfer pricing reporting requirements for goods and services provided to parent companies by affiliates in other tax jurisdictions, and vice versa. Some of these jurisdictions are considered tax havens, and the IRS seeks to capture at least a portion of the revenue lost to such arrangements.

The IRS has recently increased its international staff and its focus on midsized companies. More than 650 IRS examiners devote the majority of their time to transfer pricing issues. Transfer pricing audits have increased

substantially over the past few years. All companies with related-party transactions are required to compile documentation to support intercompany transfer pricing strategies on an annual basis prior to filing U.S. income tax returns.

Despite advice that a transfer pricing report should be prepared, many companies decide to “take their chances” that an IRS exam will not take place. By taking this chance, a company is at risk for additional tax, interest and penalties on the adjustments identified. Penalties can be as high as 40 percent of the underpaid tax. Making a good faith effort to document transfer pricing will protect companies from penalties in the event of an audit adjustment.

The transfer pricing regulations focus increasingly on the transfer of intangible assets and services, such as intellectual property, not just tangible products. IRS rules allow a company to adopt one of several methods for determining the price of services provided by or to an offshore affiliate. For example, the newly proposed “simplified cost-based method” will require that the pricing of services reflect not just the cost but also an appropriate markup based on what an independent third party would charge for the services. The “comparable profits method” determines what an arm’s-length transaction would be based on the profitability of comparable transactions by similarly situated companies.

Other methodologies are available depending on a company’s circumstances. Regardless of the methodology used, the IRS requires that it be reasonable and fully

documented. Typically, this documentation requires the assistance of international tax consultants with considerable knowledge and experience in transfer pricing and how it is treated by various tax jurisdictions.

How does a transfer pricing arrangement work?

Here’s an example of how two related companies – a subsidiary and parent located in different countries – might benefit from a transfer pricing arrangement by making a transaction in a country with a tax burden significantly less than another country.

A company subsidiary located in country A pays 20 percent tax on \$100 worth of goods, which it repackages and exports to the parent company, located in country B, at a selling price of \$200. The parent company sells the goods for \$300. Both entities have a \$100 profit. But the tax rate in country A is 20 percent, and the tax rate is 60 percent in country B, or \$60 on a \$100 profit. After taxes, the multinational company’s overall profit is \$120. (See Case 1 in chart below.)

But if the subsidiary sells the goods for \$280, and the parent sells them for \$300, the multinational’s profit increases because more of the pre-tax profits are shifted to the subsidiary in country A, where the tax rate is lower. The subsidiary now makes \$180 profit, with 20 percent of that paid in tax. But the parent company earns just \$20 on the transaction. With the tax rate of 60 percent in country B, it pays just \$12 in tax. The overall after-tax profit rises from \$120 to \$152. (See Case 2 in chart below.)

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This chart summarizes how after-tax profits result under these transfer pricing scenarios.

Case 1	Price of goods	Transfer price	Selling price
	\$100	\$200	\$300
	Subsidiary company		Parent company
Pre-tax profit	\$100	\$100	\$200
Tax rate	20%	60%	
Tax paid	\$20	\$60	\$80
After-tax profit	\$80	\$40	\$120
Case 2	Price of goods	Transfer price	Selling price
	\$100	\$280	\$300
	Subsidiary company		Parent company
Pre-tax profit	\$180	\$20	\$200
Tax rate	20%	60%	
Tax paid	\$36	\$12	\$48
After-tax profit	\$144	\$8	\$152

What is a transfer pricing study?

Transfer pricing studies are typically conducted by experienced accountants and economists with considerable background and experience in international tax matters.

A transfer pricing study examines the pricing of controlled transactions between related parties. By applying and documenting various testing methods, it attempts to determine whether the transactions were conducted at arm's length and will survive scrutiny from the IRS and other tax authorities.

IRS regulations specify that the "best method" be adopted – that is, the testing method that provides the most reliable measure of an arm's-length result under the facts and circumstances of the controlled transaction under review. A transfer pricing study will justify how a particular method is selected for the companies and transactions being reviewed.

The usual motivation for conducting a transfer pricing study is to ensure that related companies comply with IRS regulations regarding transactions between the two. However, a study can also uncover opportunities for future tax planning that can potentially reduce costs and improve operations.

How Freed Maxick & Battaglia, CPAs can help.

Freed Maxick & Battaglia's experienced international tax professionals can help ensure your company has the necessary documentation to withstand inquiries from the IRS and tax authorities throughout the world. Our objective is to ensure your company fully complies with the requirements necessary to avoid penalties, while minimizing your total tax on a global basis.

Our international tax team can provide consulting, analyze comparable company data, perform functional analysis, and prepare comprehensive transfer pricing studies. Our approach looks at each company's particular situation

and emphasizes the documentation process, risk assessment and planning opportunities – not just regulatory compliance.

Following a proven four-step process, we thoroughly analyze, evaluate and document your methodology for determining the pricing for the products, services and intangibles (trademarks, patents and copyrights) transferred between related companies.

About Freed Maxick & Battaglia, CPAs

Freed Maxick & Battaglia is the largest public accounting firm in Western New York and a Top 100 Firm in the U.S. Freed Maxick is committed to helping middle-market companies throughout the U.S. with their International Tax needs and export incentives.

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