

Transfer Pricing — The World's Top Tax Priority

Executive Summary:

Already a top priority, high-profile victories by both the US and European tax authorities are causing multinational businesses to re-examine their transfer pricing strategies, positions and documentation. The additional transparency requirements mandated by the OECD/G20 Base Erosion and Profit Shifting project will embolden tax authorities around the world to pursue transfer pricing adjustments with even greater vigor. Taxpayers must be proactive to avoid the consequences.

ValueScope is uniquely positioned to assist companies in accurately valuing, documenting and defending transfer prices between related taxpayers. Our team of international tax professionals, Phd Economists and financial analysts have the technical knowledge and industry experience to analyze transactions ranging from the simple transfer of tangible goods or provision of services to the most unique transfers of intellectual property.

Pick up the paper almost any day of the week and you can read about huge transfer pricing cases docketed for US Tax Court and about US multinationals settling equally huge European transfer pricing cases. Every country seems to have placed transfer pricing as a top tax priority. With the magnitude of the adjustments (Coca Cola proposed adjustment of \$3.3 billion, Google's \$181 million settlement with the UK and possible similar adjustments in other large Euro countries, and Apple's settlement with Italian tax authorities for \$350 million), transfer pricing will maintain a top tax priority for many years to come.

In the pages that follow, we highlight some of the top reasons taxpayers find themselves in transfer pricing controversy, the potential consequences of that controversy and how ValueScope protects and defends taxpayers from adjustment.

Reasons Why Taxpayers Get it Wrong

Waiting for the Shoe to Drop (Playing the Audit Lottery) – Some taxpayers have taken the position that

they will simply wait for the IRS to challenge them before addressing their transfer pricing issues. However, the benefit of proactively determining the arm's length price between related members of the controlled group is at least two-fold. First, it is always more cost effective to get it right the first time vs. defending a transfer price against challenge. But even more importantly, taxpayers have the opportunity to control the narrative by allocating profits to entity and jurisdiction where they can be supported by sound functional and economic analysis.

Shoddy Functional Analysis ("Let us do the functional analysis to save costs.") - Functional analysis is a methodology that is used to explain the workings of a complex system. Unless you have experience with the specific challenges that tax authorities bring in the transfer pricing area, it is difficult to know the right questions to ask.

Common errors in the functional analysis process include:

- failure to identify value-creating intangibles
- giving inappropriate weight to non-value added asset and functions
- over reliance on the contractual allocation of risks.

Uncomparable Comparables –The economic analysis found in transfer pricing reports selected for examination is many times inadequate and sometimes just plain wrong. Comparable transactions and/or profits may miss the mark because they are ultimately not comparable.

Often this is due to:

- a faulty functional analysis
- an incorrect database search
- an ignoring of potential comparability adjustments

The consequence of bad economic analysis is a meaningless and unsupported transfer price.

Unilaterally Ignoring the Other Country – By nature, there are a minimum of two tax jurisdictions impacted by cross-border transfer prices. Failure to address the issues under both sets of rules will more often than not lead to challenge by the other jurisdiction.

Selecting the Wrong Best Method – Both the IRS regulations and OECD guidelines list a number of proscribed methods for establishing an arm's length price. Taxpayers not only have the burden of selecting the best or most appropriate method, but also documenting why other methods were not selected.

Skimping on the Documentation (Can't we wait to document our answer after we get the IDR?) – In an effort to save money, rather than use IRC Sections 482 and 6662 compliant documentation, taxpayers will often document their transfer pricing methodology in one of the following ways:

- not at all
- back of the envelope
- benchmarking
- benchmarking with functional analysis.

Anything less than IRC Sections 482 and 6662 compliant documentation subjects the taxpayer to one or more of the consequences listed below.

The Consequences of Getting it Wrong

Penalties – Taxpayers with substantial, or worse, gross transfer pricing misstatements will be subject 20% or 40% penalties in addition to the tax adjustment and interest, unless ... the taxpayer is deemed to have met the transfer pricing method selection and documentation requirements of IRC Sections 482 and 6662. Meeting the standard for selection of the appropriate method can be met most easily by relying on the analysis of a qualified professional such as the professional at ValueScope.

Meeting the documentation standard requires that the transfer pricing report contain a discussion of:

- business overview which includes the economic and legal environment in which the taxpayer operates
- taxpayer's organizational structure
- method selected and why
- methods not selected and why
- controlled transactions
- comparables and any adjustments
- explanation of the economic analysis

Adjustments and Secondary Adjustments – When taxpayers get transfer pricing wrong, they are required to adjust the price on the books of each of the affected parties. This will lead to tax adjustments in at least two jurisdictions. This may also lead to deemed transfers of property (dividends, notes, etc.) to reflect the movement of cash. These secondary adjustments could attract other taxes such as withholding taxes.

Customs Audits – Income taxes are not the only taxes that are assessed on the related party transfer of tangible and intangible property and services. For example, transfer of tangible property between related parties across borders can also attract customs duties. Taxpayers can most certainly expect better coordination between income tax and customs authorities in the years to come.

BEPS/Form 5471/UTP/Fin 48 – Pick up the SEC Form 10-K of almost any multinational and you will see disclosure of transfer pricing controversy and the potential financial statement impact. The OECD and G20 leaders have been successful in requiring disclosure by large multinationals of how and where profits are allocated. The IRS requires annual disclosure of related party transactions and uncertain tax positions. Bottom line, getting the transfer price wrong will have cash and financial statement impact.

How ValueScope Can Help Get it Right

International Tax professionals + Phd Economists + Financial Analysts – The combination of these three disciplines (along with other specialists such as engineers) gives ValueScope a huge advantage over most of our competitors. From the most straightforward documentation engagement to the most complex intangible transfer, we have the skills and experience.

The Best Data – We have invested significant resources to ensure that we have access to all the data we need to accomplish our economic analysis. These include Thompson Reuters EIKON, Bloomberg/BNA, IBIS World, kt MINE and many other data resources.

Right Pricing – Our expertise compares to the global firms but our prices compare to that of a regional/local. Our clients get maximum value from us.

Extensive IRS and Taxpayer experience – In addition to our extensive experience in planning, preparing, and defending taxpayer’s transfer prices, we are frequently hired as experts by the IRS in the largest (read billions of dollars in adjustments) transfer pricing controversies. This relationship with the IRS provided our clients with two advantages.

First, we know exactly how the IRS and Treasury approach transfer pricing controversy cases.

Second, we are known within the IRS as reliable and trusted advisors such that our transfer pricing studies have never been adjusted upon exam.

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