COMPANY TAXATION
Transfer Pricing

Peters Advisors
TRANSFER PRICING • VALUATION

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International transfer pricing expert, Dan Peters of Peters Advisors, explains how the worldwide transfer pricing system works, what the OECD's Base Erosion and Profit Shifting project means, and the benefits of defensible transfer prices and Advance Pricing Agreements

Please explain how the worldwide transfer pricing system works for a multinational enterprise (MNE)? What type of documentation does a company have to prepare?

All but a few countries in the world base their transfer pricing rules on the 'Arm's Length Principle,' which essentially states that transactions between related parties should take place at transfer prices consistent with the market prices at which unrelated parties trade. Brazil is a notable exception to the rule and essentially requires taxpayers to achieve a formulary result from its transfer pricing to be in local compliance.

The 34 OECD members and most other countries apply transfer price rules and regulations that are based upon the 'OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations.' These guidelines are based upon the application of the Arm's Length Principle and provide a consistent framework for local regulations and for resolving disputes among jurisdictions.

Transfer pricing documentation requirements vary by jurisdiction both in the nature and in the timing of when it must be produced. Some countries – such as Mexico – require documentation of transfer prices with the filing of the tax return. Others – like the US – require the taxpayer to produce 'contemporaneous documentation' in the audit process that demonstrates that its transfer pricing was correct when the tax return was filed. This documentation is expected to be complete prior to filing the tax return. Lastly, some countries only require that a taxpayer defend its transfer pricing upon audit – but often demand documentation that provides that defence in very short order.

What are the potential penalties for companies if an audit results in an adjustment to their taxable income regarding transfer pricing? Is there an appeal process?

Penalties vary by jurisdiction, as well as by the amount and nature of the adjustment. In the US, penalties are non-deductible and can be quite punitive – up to 40% of the increase in tax for a large adjustment. Audit adjustments generally can be appealed and ultimately litigated, if necessary, but there is no guarantee of a successful outcome. US taxpayers with properly developed transfer pricing documentation are much less likely to incur penalties if faced with a transfer pricing dispute with the IRS.

Another potential 'penalty' to consider for incorrect transfer pricing is double taxation. An increase in taxable income in one jurisdiction that results from a tax audit does not guarantee relief in terms of reducing the tax due in the counterparty jurisdiction. Sometimes the cost and complexity of obtaining a settlement between the jurisdictions is so great that taxpayers choose not to seek relief. Generally, transfer pricing disputes can be resolved between countries with tax treaties and processes to resolve disputes – but this process is long, costly and uncertain.

What is the current regulatory environment as it relates to transfer pricing?

The regulatory environment is more difficult than ever. Tax authorities have become frustrated with what they perceive as inappropriate transfer pricing by sophisticated MNEs. Transfer pricing techniques have recently received extensive coverage in the media and drawn the attention and ire of the G20, the United Nations and other governing bodies.

These concerns have become so significant that the OECD has commissioned a special project to essentially re-write many aspects of the OECD Transfer Pricing Guidelines. This project – known as Base Erosion and Profit Shifting, or BEPS – will significantly shift the playing field in transfer pricing matters towards the tax authorities. Most of the major aspects of BEPS that relate to transfer pricing have already been issued in draft and will be finalised in 2015. Certain countries are already adopting some of these changes and they will certainly be fully implemented by 2016.

How do tax directors and financial controllers of corporations operating in the US ensure if they are audited they do not incur significant costs and penalties?

In the US, transfer pricing penalties are only assessed when there are significant adjustments to taxable income. So the best protection from penalties is to have defensible transfer prices, which are supported by transfer pricing documentation prepared prior to issuing the tax return (contemporaneous documentation). If a taxpayer has contemporaneous documentation, it is unlikely to incur penalties even if its US taxable income comes into dispute.

Another way to obtain certainty in transfer pricing matters is to pursue and obtain an Advance Pricing Agreement (APA). An APA is essentially an agreement between the taxpayer and the tax authority regarding the company's future transfer pricing. APAs can be difficult, costly to obtain, usually take a long time, and are not available in all jurisdictions. In today's world, most APAs are 'bilateral', meaning a joint agreement between both tax authorities and the taxpayer. Despite the challenges associated with APAs, taxpayers with a long view often consider APAs a great way to obtain certainty of outcome and to minimise the annual cost of compliance.

Which types of companies are more likely to face audit risk in transfer pricing?

Companies with significant intercompany transactions with tax-favoured jurisdictions (such as Switzerland) or especially tax havens (e.g. Cayman Islands) should always expect high levels of scrutiny of these transactions. Also, companies with significant intellectual property and/or high profitability have always been obvious targets. But in the 'post-BEPS world' essentially all intercompany transactions that are designed to shift risks – and thus income – from high-tax jurisdictions to low-tax jurisdictions will likely be challenged.

The BEPS project is introducing a concept it calls 'Country-by-Country' reporting, or CbC, which will require a multinational group to disclose to all tax authorities extensive information regarding its financial results in each country. This level of transparency is going to change transfer pricing audits significantly.

What types of intercompany transactions are most controversial and how should those risks best be managed?

Intercompany transactions of intellectual property are obviously controversial. But we see higher levels of scrutiny across all types of transactions – tangible goods, services, and financing - especially when one of the entities is structured for tax purposes as having limited risks or functions.

We have found the best approach to managing transfer pricing risks is to be in command of the facts on the ground. Taxpayers that have properly studied and documented the nature of the activities performed, the tangible and intangible assets employed, and risks taken by the transacting parties, can address any reasonable audit question - if their resulting transfer pricing decisions have been sensible.

Please give the readers of Finance Monthly magazine an overview of the latest and most significant updates relating to the worldwide transfer pricing environment?

The BEPS initiative is really a game-changing event in the transfer pricing world. The only remotely comparable event in recent history was when the US first required taxpayers to produce contemporaneous documentation way back in 1995.

BEPS essentially changes the rules and the information available to tax authorities in ways that will limit the abilities of taxpayers to use transfer pricing techniques to obtain one-sided results where a tax-favoured entity earns extraordinary profits. That is going to have a profound impact on large MNEs. Companies with transfer pricing structures that today are not sustainable in a post-BEPS world should be considering restructuring their transaction flows and transfer pricing policies to obtain sustainable benefits.

What role does technology play in transfer pricing and how feasible is this for corporations to adopt?

Technology is critical today in terms of managing intercompany transactions and supporting the information requirements necessary to satisfy a company's financial and tax auditors. The role of technology increases significantly with the complexity of the company's supply chain. Companies with multiple divisions and/or multi-level manufacturing need technology-based solutions to manage the requirements and maximise the opportunities of today's transfer pricing environment.

Adopting technology-based solutions can be a real challenge. Many companies have failed in implementing these sorts of programmes.

How do you best help companies manage their transfer pricing issues and what services do you provide?

The professionals in our firm specialise in transfer pricing matters. We work closely with our clients on any and all aspects of transfer pricing – from planning or restructuring an intercompany transaction, to complying with both tax reporting and financial accounting in every country that they operate, and in assisting with audits, resolution processes and even litigation with tax authorities.

About Dan Peters

Dan Peters has practiced transfer pricing since 1993. He became partner at KPMG and moved to London in 1999 to lead the European transfer pricing team of that Firm. He returned to the US in 2000 and led KPMG's Transfer Pricing and Valuation practice until leaving the Firm in 2005. In 2004, Dan became Managing Partner of KPMG's Global Transfer Pricing Services practice.

Dan joined Duff & Phelps in 2006 to build a world-class transfer pricing practice, and eventually led that Firm's entire Tax practice as well as its Financial Advisory segment. Dan left Duff & Phelps in 2009 to found Peters Advisors LLC.

Dan has been named as a "Leading Transfer Pricing Advisor" consistently in client surveys by the Legal Media Group since 2001, and has been nominated as among the "Best of the Best" in the U.S. Dan has led teams that have been awarded numerous accolades.

He has had the privilege of serving many of the world's leading multinational firms in their transfer pricing and tax valuation matters. Dan has worked in numerous industries, with specific expertise in industrial and high technology manufacturing, life sciences (pharmaceutical and healthcare device), telecommunications, transportation, consumer products (food, beverage, retail), software development and internet based businesses, and all aspects of the financial services industry.

His experience and expertise ranges across the entire range of transfer pricing transactions (intellectual property, tangible goods, services, and financing) and effective global planning, efficient compliance, and managing controversies.

Dan has written and presented extensively regarding transfer pricing and tax valuation matters, and developed and has taught "Valuation Principles in Transfer Pricing" for the ASA's Center for Advanced Valuation Studies.