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Transfer Pricing: International Trends, Controversy and Strategy

HLB North America Tax Conference
December 5, 2014

Agenda

- Introduction to WTP Advisors
- Overview of transfer pricing
- Global transfer pricing landscape
- Leading practices
- Case studies
- Summary

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Introduction to WTP Advisors

- International tax specialty services firm
  - Over thirty international tax and transfer pricing specialists located throughout the U.S.
  - Affiliates located throughout the world
- Private Company International Tax Services
  - International Structuring
  - International Tax Compliance
  - Foreign Tax Credit Utilization
  - Repatriation Planning
  - Foreign Earnings & Profits
  - Inbound Tax Planning
  - Expense Allocation and Apportionment

Introduction to WTP Advisors (Continued)

- Private Company International Tax Services (Continued)
  - IC-DISC Export Incentives
    - Formation
    - Commission Optimization
    - Compliance
      - Qualification
      - Tax Returns
  - Domestic Production Deduction Incentive
  - Transfer Pricing
    - Planning
    - Compliance
    - Tax Controversy Support

Introduction to WTP Advisors (Continued)

- How does WTP work with CPA firms?
- Whatever works best for the CPA and its clients
  - Provide full international tax and transfer pricing support
  - Supplement existing international tax and transfer pricing internal resources
  - Direct contact
  - "Backroom support"
  - Quality Control
  - We work with our network or work with your network, whatever makes the most sense

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Overview of our transfer pricing practice

- Senior members with over fifteen years of experience
  - PhD economists, CFAs, CPAs
  - Flexible, collaborative team
- Subscribe to various company and license agreement databases for benchmarking
- Data management and analysis capabilities
- Global network

The Transfer Pricing Specialists

Amsterdam, Brisbane, Cologne, Eindhoven, Genoa, Ho Chi Minh City, Hong Kong, Jakarta, Kuala Lumpur, Shanghai, Singapore, Sydney, Zurich

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Overview of transfer pricing

- Transfer pricing: the price paid in controlled transactions
- Main types of controlled transactions
  - Tangible goods
  - Intangible property ("Normal" versus "High-value" Intangibles)
  - Services ("Routine" versus "High-value" Services)
  - Financing (Loans, guarantees, etc.)
- Most countries require companies to demonstrate that their controlled transactions are arm's length
  - Primary concern: whether the taxable entities operating in the country are recognizing their fair share of operating profit

TP tax risks and opportunities

- Risks
  - Non-deductible penalties and interest
  - High effective tax rates
    - Double taxation
    - Tax losses in some jurisdictions while earning tax profits in others
    - Attributing too much income in high tax jurisdictions
  - Overpaying or underpaying customs duties
  - Controversy through inability to articulate TP positions
  - Reputation
- Opportunities
  - Enable tax planning opportunities
  - Strategically locate intangible assets and risks in favorable jurisdictions to manage effective tax rates

Controlled transactions

Section 482-1(i)(4)

"Controlled includes any kind of control, direct or indirect, whether legally enforceable or not, and however exercisable or exercised, including control resulting from the actions of two or more taxpayers acting in concert or with a common goal or purpose. It is the reality of the control that is decisive, not its form or the mode of its exercise. A presumption of control arises if income or deductions have been arbitrarily shifted."

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Arm's length standard / Principle

- Adopted by most OECD countries
  - Behavior versus results
- Arm's length principle (OECD Transfer Pricing Guidelines)
  - When the price paid between related parties is the same as the price that would have been paid between unrelated parties under the same or similar economic circumstances
- Arm's length standard (§ 1.482-1(b)(1))
  - A controlled transaction meets the arm's length standard if the 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 (arm's length result).

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Standards of value

Valuation	Transfer Pricing for Tax Purposes
• Fair market value (FMV) – Willing buyer/willing seller – Used for business and tax valuations • Fair value – Current transaction – Used in GAAP reporting and tax courts • Investment value – Value to a specific buyer or seller – Typically includes synergies – Used in M&A decision making	• Arm's length standard – Unrelated / uncontrolled parties – Typically measured at the operating income level – Used to determine pricing for intercompany transactions

Special circumstances

(i) Market share strategy

"In certain circumstances, taxpayers may adopt strategies to enter new markets or to increase a product's share of an existing market (market share strategy). Such a strategy would be reflected by temporarily increased market development expenses or resale prices that are temporarily lower than the prices charged for comparable products in the same market … In any case, the effect of a market share strategy on a controlled transaction will be taken into account only if it can be shown that an uncontrolled taxpayer engaged in a comparable strategy under comparable circumstances for a comparable period of time, and the taxpayer provides documentation that substantiates the following ----

(A) The costs incurred to implement the market share strategy are borne by the controlled taxpayer that would obtain the future profits that result from the strategy, and there is a reasonable likelihood that the strategy will result in future profits that reflect an appropriate return in relation to the costs incurred to implement it;

(B) The market share strategy is pursued only for a period of time that is reasonable, taking into consideration the industry and product in question; and

(C) The market share strategy, the related costs and expected returns, and any agreement between the controlled taxpayers to share the related costs, were established before the strategy was implemented."

Establishing arm's length pricing

The transfer pricing process

Collect and Aggregate Data → **Analyze Data** → **Prepare / Update Documentation**

Collect and Aggregate Data:

- Surveys
- Information requests
- Financial systems
- Time tracking
- Management dialogue
- Interviews
- Financials
- Internal comparables
- External comparables

Analyze Data:

- Data analytics
- Functional analysis
- Comparables analysis
- Best method analysis
- Profit split analysis

Prepare / Update Documentation:

- Business Unit
  - Global
  - Regional
- Country specific

Global transfer pricing landscape

- Trends
  - Concerns about multi-nationals moving profits to favorable tax jurisdictions
  - More entrenchment in positions
  - More litigation
- OECD Base-Erosion Profit Shifting ("BEPS") Initiative
  - Intangibles
  - Country by Country ("CbC") reporting
- Multi-state tax commission
  - Arm's-length adjustment ("ALAS") advisory group

Examples of jurisdictions / tax rates[1]

Jurisdiction	Tax Rate
United States	34% - 39.6%
Brazil	34%
France	33.33% - 38%
Canada	25% - 31%
Australia	30%
Mexico	30%
Germany	30% - 33%
China	25%
United Kingdom	21%[2]

Jurisdiction	Tax Rate
Luxembourg[3]	29.22%
The Netherlands[3]	25%
Switzerland[3]	18% - 24%
Singapore[3]	17%
Hong Kong	0% - 16.5%
Ireland	12.5%
Cyprus	10%
Barbados	1% - 2%
Cayman	0%

[1] This table is for illustrative purposes only. Effective tax rates vary based on facts and circumstances. Statutory rates routinely change over time.
[2] This rate will drop to 20 percent in 2015. Also, the U.K. offers an attractive Patent Box Regime.
[3] Country offers possible opportunities to negotiate lower effective tax rates.

Areas of potential controversy

- Intercompany services
  - Are service provider entities undercharging for services?
  - Are service charge recipient entities overpaying for services?
- IP migration /cost sharing / buy-in payments
  - Is IP being transferred below arm's length value?
  - Are the entities that funded up front R&D costs appropriately remunerated for the risks they undertook?
- Guarantee fees
  - Are parent companies appropriately charging out guarantee fees in situations when subsidiaries benefit from favorable credit ratings?
- Supply chain restructurings
- Permanent establishments / Nexus
- Appropriate characterization of transactions (services, debt, equity)

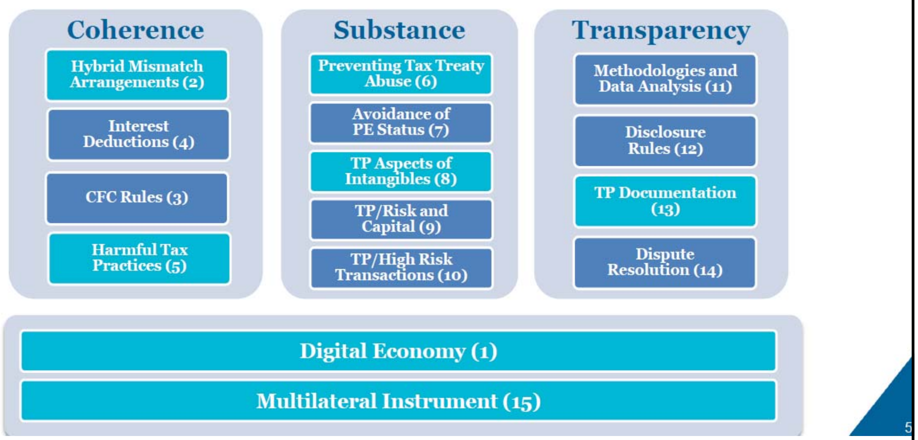
Company profiles

- Category 1: Obtuse
  - Ignoring transfer pricing regulations and conducting intercompany transactions that are not arm's length
- Category 2: Aggressive planners
  - Developing and implementing global effective tax management policy – taking aggressive positions that push the limits of the arm's length standard
- Category 3: Prudent planners
  - Developing and implementing comprehensive global effective tax management policy –taking a prudent or conservative approach with robust documentation and support
- Category 4: Compliance-oriented
  - Focused on adhering to the arm's length standard. Their primary objective is to avoid controversy

What is BEPS?

- Initiative undertaken by OECD and G20 countries to create a single set of consensus-based international tax rules
- "Action Plan" published July 2013 summarizes goals:
  - Eliminate "double non-taxation"
  - Tax revenue in the geography where value is created
  - Address hybrid mismatches
  - Minimize "treaty shopping"
  - Prevent "abuse" of transfer pricing rules through use/movement of intangibles
  - **Implement CbC reporting detailing the global allocation of profits, economic activity and taxes of multinational enterprises ("MNEs")**

The BEPS Project



BEPS activity in 2014

- On September 16, 2014, seven of the fifteen action points defined in the 2013 Action Plan were addressed through a series of deliverables
  - Action 1: Digital economy
  - Action 2: Hybrid mismatch arrangements
  - Action 5: Harmful tax practices of countries
  - Action 6: Addressing treaty abuse
  - Action 8: Transfer pricing for intangibles
  - Action 13: Country-by-Country reporting and transfer pricing documentation
  - Action 15: Multilateral instrument
- The remaining eight action points will be addressed in 2015

Action 13: Deliverable overview

- New rules define a three-tiered documentation structure
  - Master file
    - A high level "blueprint" of the MNE's structure and operations
  - Local file
    - Outlines material transactions
    - Demonstrates compliance in a specific jurisdiction
  - CbC report
    - Shows global allocation of MNE's income and taxes paid
    - Indicates location of economic activity within the group
    - Can and should consider materiality of transactions
- All three reports should be updated annually
  - Acknowledge that business descriptions, functional analyses, and comparables may not change significantly from year to year

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Guidance on TP documentation

TP documentation objectives

1. Provide tax administrations with the information necessary to conduct an informed transfer pricing risk assessment
2. Ensure that taxpayers give appropriate consideration to transfer pricing requirements in establishing prices … and in reporting the income derived from such transactions in their tax returns
3. Provide tax administrations with the information that they require in order to conduct an appropriately thorough audit of the transfer pricing practices of entities subject to tax in their jurisdiction

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Master file

Objective: Provide high-level overview to place the MNE group's transfer pricing practices in their global economic, legal, financial and tax context

- Five categories
  1. Organizational structure
  2. Description of the MNE's business (including functional analysis)
  3. MNE's Intangibles
  4. MNE's intercompany financial activities
  5. MNE's financial and tax positions
- Can be presented for the MNE as a whole or by line of business
- "Information is considered important if its omission would affect the reliability of the transfer pricing outcomes"*

*Source: "Guidance on Transfer Pricing Documentation and Country-by-Country Reporting", paragraph 18

Local file

Objective: Provide more detailed information relating to specific intercompany transactions

1. Local entity information
   - Management structure
   - Business strategy
   - Key competitors
2. Controlled transactions
   - Comparability and functional analysis (may overlap with master file)
   - Discussion of transfer pricing methods
   - Selection of tested party
   - An explanation for performing a multi-year analysis (if relevant)
3. Financial information

Country-by-country report

- Objective: Provide tax authorities with information to enable high-level transfer pricing risk assessments
  - Evaluate BEPS related risks
  - Used to perform economic and statistical analysis where appropriate
  - "… the information in the country-by country report should not be used as a substitute for a detailed transfer pricing analysis of individual transactions and prices based on a full **functional analysis** and a full **comparability analysis**"*
- "It should not be used by tax administrations to propose transfer pricing adjustments based on a global formulary apportionment of income"*

*Source: "Guidance on Transfer Pricing Documentation and Country-by-Country Reporting", paragraph 25

CbC model templates

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

Name of the MNE Group:
Fiscal year concerned:

Tax Jurisdiction	Revenues			Profit (Loss) Before Income Tax	Income Tax Paid (on cash basis)	Income Tax Accrued - Current Year	Stated Capital	Accumulated Earnings	Number of Employees	Tangible Assets other than Cash and Cash Equivalents
	Unrelated party	Related Party	Total							

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Note: Profit before income tax as opposed to operating profit

Likely to be used as a key "economic activity indicator" by developing countries

CbC model templates (continued)

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

Name of the MNE Group:
Fiscal year concerned:

Tax Jurisdiction	Constituent Entities Resident in the Tax Jurisdiction	Constituent Entities Resident in the Tax Jurisdiction	Main business activity(ies)												
			Research and Development	Holding or Managing Intellectual Property	Purchasing or Procurement	Manufacturing or Production	Sales, Marketing or Distribution	Administrative, Management or Support Services	Provision o Services to Unrelated Parties	Internal Group Finance	Regulated Financial Services	Insurance	Holding Shares or Other Equity Instruments	Dormant	Other[2]
	1.														
	2.														
	3.														
	1.														
	2.														
	3.														

[2]Please specify the nature of the activity of the Constituent Entity in the "Additional Information" section.

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CbC model templates (continued)

Table 2. Additional Information

Name of the MNE Group:
Fiscal year concerned:

Please include any further brief information or explanation you consider necessary or that would facilitate the understanding of the compulsory information provided in the country-by-country report.

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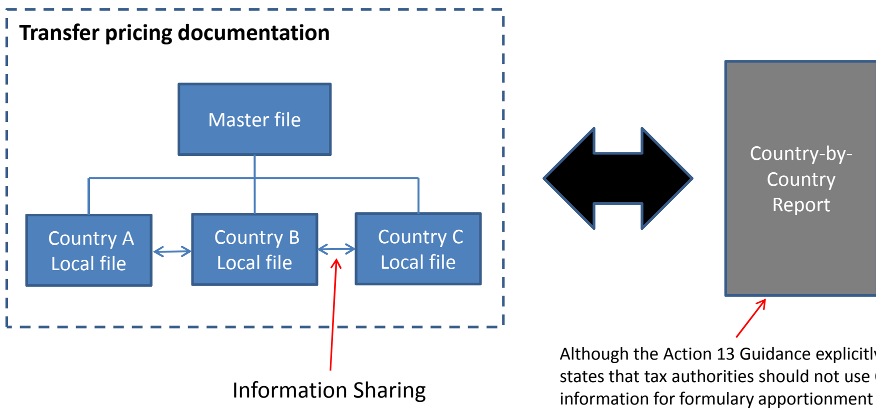
This is your opportunity to put the CbC information into context

The challenge



Although the Action 13 Guidance explicitly states that tax authorities should not use CbC information for formulary apportionment of income, the document refers to this data "**economic activity indicators**."

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Additional guidance: Timeframes / updates

- Recommend setting prices in advance (planning) and test contemporaneously with tax filing (documentation)
- CbC compilation deadline may be extended to one year following the last day of the fiscal year of the ultimate parent of the MNE group
- Frequency of documentation updates
  - In general, the master file, local files and CbC report should be reviewed and <u>updated annually</u>
  - If operating conditions remain unchanged, <u>update comparables every three years</u>
  - However, <u>financial data of the comparables should be updated every year</u> in order to apply the arm's length principle reliably

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Additional guidance: Materiality thresholds

- Based on facts and circumstances
- Should be objective standards that are commonly understood and accepted in commercial practice
- Considerations
  - Size and nature of the local economy
  - The importance of the MNE in that economy
  - The size and nature of the MNE group
- Basis
  - Absolute amounts
  - Percentage of revenue or percentage of cost measures

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Importance of transfer pricing for M&A

- M&A activity has increased recently (especially relative to 2008)
- An M&A transaction is also a tax planning opportunity
- Should be considered at each of the three M&A stages
  - Planning and due diligence
  - Transaction
  - Integration
- Transfer pricing considerations can also influence M&A transaction funding
  - Whether debt will be a material part of funding
  - Impact of intercompany transactions on third party loan guarantor entities

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Case studies

- Case study 1: Permanent establishment (PE)
- Case study 2: Excess capacity / losses
- Case study 3: International growth strategy

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Case study 1: Permanent establishment

- US Parent
  - HQ of the company
  - Purchases debt from third parties and collects it
- Canada activity
  - Operating in Canada for over three years
  - Opened up an office this year to increase its presence in Canada
  - One contractor (a Canadian citizen)
- Questions for the group
  - Did our client have a PE before they opened up their office?
  - Does our client have a PE now that the company has opened up an office in Canada?
  - If there is a PE, how should we attribute profit to the PE?

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Case study 2: Excess capacity / losses

- US headquartered company
- Opened up a manufacturing facility in Asia
  - Increase manufacturing capacity
  - Establish presence in strategic market
  - Tax holiday
- Volumes did not increase as hoped – leading to unused capacity and losses in Asia
- To avoid losses in Asia, the company charged "production charges" to the U.S.
- Questions for the group
  - What questions should the tax return preparer ask?
  - Do you see any issues with the facts above?

Case Sudy 3: International growth strategy

- A US-based medical products client engaged us to develop transfer pricing and tax structuring recommendations that would enable the company to maximize after-tax free cash flow to shareholders
- A key aspect of the project was to determine the most effective intangibles ownership policy
  - Technology developed primarily in the U.S. – although the company had some activity in the NL
- Questions for the group
  - What options does the company have in structuring its TP for its R&D and intangibles?
  - What are the pros and cons of these options?

Case study 3 (continued)

Transactions under review:

- Transaction One: US Parent's sale of certain Technology Intangibles rights to the NL Affiliate
- Transaction Two: Ongoing performance of research and development ("R&D") activities by the US Parent and the NL Affiliate (as a service or pursuant to a cost sharing arrangement ("CSA") between the entities)
- Transaction Three: US Parent's provision of services to the NL Affiliate

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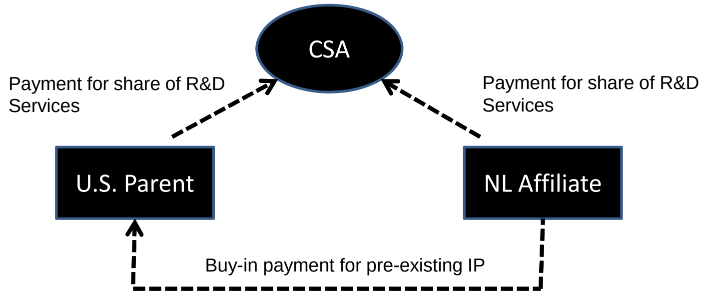
Cost sharing arrangements (CSAs)



Under a CSA, a foreign affiliate of a U.S.-based Parent enters into an agreement with the U.S. Group to:

1. Buy the economic rights to exploit pre-existing IP outside the U.S.
2. Share in the costs of developing future IP

As a result, each entity owns the economic rights to exploit the IP within a field of use or territory

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Key questions for businesses to consider

- What are the company's current and future intangible assets?
- How will the business evolve over the coming five to ten years?
- Is the business becoming more global?
- Which markets (product and geographic) will the business enter?
- Is the business centralizing or decentralizing activities?
  — Regionally
  — Globally

Leading practices

- Be aware of the OECD's progress on BEPS, and the direction this work is taking
  — The OECD's initiatives are ongoing and are impacting MNEs' exposures to transfer pricing risks
  — Being aware of the likely requirements will make transition easier
- For CPAs - be aware of what your clients are doing/where they have activities
  — Even the smallest client may provide goods/services internationally, use a foreign supplier, or have a foreign bank account
  — Educate clients as to risks and requirements of operating internationally
  — Make sure your engagement letters protect you and your firm from liability should there be any "surprises"
  — Partner with firms that provide transfer pricing international tax services to help mitigate risk when necessary

Transfer pricing process

- Phase 1: Review
  - Identify intercompany transactions
  - Understand business plans and international growth strategy
  - Evaluate risks and identify planning opportunities
- Phase 2: Design
  - Develop an intercompany transactions and intangibles ownership policy that supports business and tax objectives
  - Develop a transfer pricing documentation plan to address risks
- Phase 3: Implement / document transfer pricing policy
  - Administer intercompany transactions
  - Prepare or update transfer pricing documentation and intercompany agreements
- Review annually and whenever there are significant business changes

Discussion / Q&A

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