

Transfer Pricing: Audit Considerations



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Transfer Pricing Basics

- Price at which tangible property, intangible property, services, and financing / leasing are transferred between related entities of an organization, across both international and state borders
- “Fair” share of operating profit between related entities
 - Fairness based upon functions performed and risks assumed
 - Profit flows to entity with more / complex functions, bearing more risks



Universal Principles

- Arm's-length standard
 - Results of the transaction are consistent with the results that would have been realized by unrelated third parties
 - Transfer price should compensate parties for functions performed, assets owned, and risks undertaken
- Best / most appropriate method
 - Method that provides the most reliable indication of an arm's-length result
 - No hierarchy of methods
- Arm's-length range



What to Look For

- Companies with entities in multiple countries/states appearing to lack arm's-length pricing
 - Legal entities with operating losses
 - High operating profit margins for limited risk / captive entities
 - High R&D/sales but lack royalty income
- Entity sells goods or provides services to related entity at a price different than to unrelated entity
- Related entities utilizing know-how, trademarks, processes, or ideas to earn a profit without paying royalties
- Parent company does not charge subsidiaries for provision of services (e.g., IT, HR, or strategy)
- Related party financing with no interest rate or abnormally high interest rate

Example



- Manufactures blenders
- Sells blenders to Chinese sub at resale minus
- Performs all R&D
- Sells US-sourced blenders to Chinese customers
- Manufactures blenders and sells to Chinese customers

Questions:

- How did China get technology and know-how to make these blenders?
- Under what brand is China selling it's locally manufactured products?
- What services is USP providing to its Chinese sub?
- Segmented profitability? Overall profitability?
- Materiality?

Questions?



Thank you for your time and participation!



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