

Transfer Pricing: Applied Reality, Trends, & Pitfalls



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Learning Objectives

- Reinforce understanding of transfer pricing basics
- Appreciate the applied reality of transfer pricing
- Recognize the trends due to BEPS/regulatory changes
- Learn some common pitfalls to avoid

Transfer Pricing Basics



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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

Transfer Pricing Applied Reality



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Applied Reality

- Numerous profit- and transaction-based methods exist
- Method most often applied: comparable profits method (CPM) / transactional net margin method (TNMM)
 - Compares functionally-similar companies' *interquartile range* of operating results to *tested party's*
 - Often most reliable data available (e.g., audited SEC filings) and applicable *profit level indicator*
 - Regulations require comparable operating NOT gross profit (i.e., attempt to capture total cost)
 - Often default method of tax authorities



Case Study #1

- Starkman US builds dry fertilizer storage buildings for customers
- Historically provided these construction services in the US only
- Some of its US customers are now expanding into Canada and need services there
- Starkman Canada entity was created to service those needs

Starkman – CPM / TNMM

- Client inquired about how to charge for all activities Starkman US performs that benefit Starkman Canada
 - Unnecessarily complicated
 - IRS/CRA concerned with taxable income
- Starkman Canada provides general contractor services to Starkman US; bears little risk; and earns a routine ROTC (let's say 5%)
- Starkman US manages, organizes, and oversees all operations in Canada; bears most risk; and earns residual profit

Starkman – CPM / TNMM (cont'd)



Revenue	105	Revenue	200	Revenue	200
Cost of Services	(90)	Cost of Services	(105)	Cost of Goods	(90)
Gross Profit	15	Gross Profit	95	Gross Profit	110
Operating Expenses	(10)	Operating Expenses	(80)	Operating Expenses	(90)
Operating Profit	5	Operating Profit	15	Operating Profit	20

BEPS/Regulatory Update



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Post-BEPS Environment

- Final recommendations on 15 Action Items issued by the OECD
- Lay the foundations of a modern international tax framework
- Profits are taxed where economic activity and value creation occurs
- Support the implementation of the recommended changes in a consistent and coherent manner
- Monitor the impact on double non-taxation and on double taxation
- Design a more inclusive framework to support implementation and carry out monitoring



Actions 8-10 – Aligning Transfer Pricing Outcomes with Value Creation

- Action 8 addresses outcomes differing from TP study and intangibles
- Action 9 addresses contractual allocations of risk
- Action 10 addresses profit allocations and other non-value creating activities

MORAL – Legal ownership of an intangible does not necessarily provide a right to the return generated from its use. Returns accrue to the business units that carry out development, enhancement, management, protection, and exploitation in relation to that intangible.



Action 13 – Transfer Pricing Documentation and Country-by-Country Reporting (CbCR)


- CbCR (USD €750 million global revenue threshold)
 - Provide information related to global allocation of income, taxes paid, and indicators of economic activity
 - Submit to jurisdiction of residence
- Master file report
 - Provide overview of business and transfer pricing practices
 - Submit to jurisdictions that require it
 - Revenue thresholds vary by country (e.g., the Netherlands)
- Local file report
 - Provide relevant transfer pricing information and analysis to particular local country
 - Submit to jurisdictions that require it

»» Ever Changing Adaptation

“Change is the only constant in life.”

- Heraclitus, Greek philosopher and transfer pricing expert

[LINK to HLBI Transfer Pricing Knowledge Group](#)



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Say what is on your mind... 400

 **Marcus Kunert** replied to [U.S. 385 Final Debt-Equity Regulations Summary](#)
1 month ago

Hi Jason, Many thanks for the update on this issue. We have got some clients who have already been aware of the intended changes of the IRS. So it...

Members



[View all \(40\)](#)



Marcus Kunert

- HLB Stückmann, Germany
- Transfer Pricing Specialist
- 15 years of TP experience



Jason Fritts

- Eide Bailley, USA
- Transfer Pricing Specialist
- 13 years of TP experience

Case Study #2

- B-Ross Inc. provides infrastructure and natural resource consulting
- Transfer pricing documentation handled centrally in the U.S.
- B-Ross Inc. operates in six regions and 50+ countries
- Most countries previously required local file report, but nothing more

B-Ross Inc. – Locations

- Major locations include the following:

Region	Country
Asia Pacific	Australia
	China
Canada	Canada
Europe	United Kingdom (11%)
	Poland
Latin & South America	Argentina
Middle East, North Africa, & India	United Arab Emirates
	India
United States	United States (67%)

Action 13 Adoptions

Region	Country	Master File	Local File	CbCR	MCAA
Asia Pacific	Australia	Yes	Yes	Yes	Yes
	China	Yes	Yes	Yes	Yes
Canada	Canada	No	Yes	Yes	Yes
Europe	United Kingdom (11%)	No	Yes	Yes	Yes
	Poland	Yes	Yes	Yes	Yes
Latin & South America	Argentina	TBD	Yes	TBD	Yes
Middle East, North Africa, & India	United Arab Emirates	TBD	TBD	TBD	No
	India	Yes	Yes	Yes	Yes
United States	United States (67%)	No	Yes	Yes	No



B-Ross Inc. – Documentation Issues

- Master file:
 - Likely never created a master file in the past or created one that is now too robust
 - Must figure out which of its 50+ countries require it and submit it to those jurisdictions when necessary
- Local file:
 - Likely took a strategic approach to its efforts on documentation
 - Created local files for some countries, but not for others
 - Local supplements don't meet local file requirements
 - Must figure out new requirements in 50+ countries and submit to those jurisdictions when necessary



B-Ross Inc. – Documentation Issues (cont'd)

- Guidance on gap period still outstanding
- Due dates vary and some approaching soon
 - Korea – new proposed regulations change due date from 3 months after FYE to 12 months after FYE for CbCR, master file, and local file
 - Poland – likely will require CbCR information with tax return due 3 months after FYE (master file and local file not due until 2018)
 - China – requires CbCR, master file, and local file with tax return due 5 months after FYE



B-Ross Inc. – Documentation Issues (cont'd)

- Definition of data to collect may not occur until OECD 2020 status review of BEPS project – use narrative section in the interim to describe
- Assess from a systems standpoint how to collect the necessary data for Form 8975
 - Reconciliation of data on Form 8975 with transfer pricing documentation reports, legal entity statutory books, and publicly available information

CbCR Timing Mismatch

- OECD – MNEs exceeding €750 million in global revenue for FYs beginning on or after January 1, 2016
 - Certain countries, e.g., France, include a one-year exemption recognizing timing issues between countries
- United States – MNEs exceeding \$850 million in global revenue for FYs beginning on or after June 30, 2016
 - Form 8975 electronically filed with the ultimate parent entity's income tax return for the taxable year
 - Confidentiality similar to tax returns applies
 - Guidance on gap period still to come

»» CbCR Timing Mismatch (cont'd)

- OECD formally approved parent surrogate filing on August 16th to address gap period
 - The United States has confirmed with the OECD that this option will be available to its residents, but has not provided instructions yet
 - There are still many outstanding questions:
 - Form 8975 guidance has not been provided yet
 - Will the United States be ready to accept the Form 8975 before the CbCR information is due in other countries?
 - The United States has not signed the MCAA or bilateral agreements to share the CbCR information

CbCR Information Sharing

- Multilateral Competent Authority Agreement (MCAA)
- Most countries have signed this, but the United States has not
- United States will pursue bilateral agreements to ensure data confidentiality
 - European Union (EU) has threatened public disclosure of some CbCR information

Final U.S. 385 Regulations

- Final § 1.385 regulations issued Oct. 13, 2016
 - No application to foreign borrowers
 - Limited application to U.S. borrowers
 - Eliminated the bifurcation rule
 - Documentation rules limited
 - Recharacterization rules
- Could impact domestic companies and foreign companies with U.S. operations
- Specifically, may require modifications to organizational structures, funding strategies, and related processes and technology in order to mitigate the risk of having debt recharacterized as equity

➤➤➤ Moral of Related Party Financing

- Transfer pricing rules apply regardless of § 385
- There couldn't be a better time to review related party financing
- Documentation increasingly necessary
- Keep an eye out for planning opportunities
 - Rate changes
 - Existing debt with high interest rates in low tax jurisdictions

Transfer Pricing Common Pitfalls



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Profit Splits – Current Status

- OECD public consultation October 11-12 to discuss revised guidance on profit splits and the resulting aggregation of transactions
 - More preference towards profit splits as the best method or at least as a corroborating method because looks at both sides of transaction
 - “Highly integrated business operations may involve the sharing of functions, where the outcome of the transaction is dependent on two or more parties making contributions which are interlinked and thus cannot reliably be evaluated in isolation.”

➤➤➤ Profit Splits – Concerns Shared

- Concern with more frequent use of profit splits:
 - One-sided methods are still appropriate and reliable in many situations
 - Profit splits used in isolation or as a corroborative method may improperly suggest higher returns to entities performing routine functions that can be reliability benchmarked

Profit Splits – Mechanics

- Reflects the relative contribution of each party in the transaction
- Applicable if both parties in transactions contribute intangible assets
- Two types of PSMs
 - Comparable profit split
 - Compares the division of profit to the division of profit among third parties engaged in similar activities
 - Residual profit split
 - Rewards each entity for routine functions and splits the residual profit (usually based on transactions or non-routine contributions)

Starkman Example – Profit Split



Revenue	105	Revenue	200	Revenue	200
Cost of Services	(90)	Cost of Services	(105)	Cost of Goods	(90)
Gross Profit	15	Gross Profit	95	Gross Profit	110
Operating Expenses	(10)	Operating Expenses	(80)	Operating Expenses	(90)
Operating Profit	5	Operating Profit	15	Operating Profit	20

Note: A red arrow points from the 105 in the first table to the (105) in the second table. The 20 in the third table is circled in red.

- How should the consolidated operating profit earned by the system be allocated?
- Are there comparable uncontrolled transactions involving a profit split or should the residual profit split method be used?



Starkman Example – Profit Split (cont'd)

Routine Functions	
<i>Target Profitability:</i>	
	<u>Costs</u> <u>ROTC</u> <u>Profit Earned</u>
Starkman Canada – General Contractor Services	100 5% 5
Starkman US – Management Services	90 10% 9
Routine Profit	14
Non-Routine Functions	
Total Profit	20
Remaining Profit	6
	<u>Relative Share</u> <u>Profit Earned</u>
Starkman Canada	50% 3
Starkman US	50% 3
Profit by Entity	
	<u>Starkman Canada</u> <u>Starkman US</u>
Routine profit	9
Non-Routine profit	3
Total	12

➤➤➤ Miscellaneous Items – CUP

- Comparable uncontrolled price (“CUP”) method is sometimes a preferred method by tax authorities, but it is often misused
- Comparability of functions, contractual terms, risks, economic conditions, and products is key
- Example:
 - ABC Co. sells products to unrelated party as well as related party
 - ABC Co. uses sale price to unrelated party as sale price to related party



Miscellaneous Items – CUP (cont'd)

- CUP method could be the best method, so long as the high degree of comparability is met
 - Similarity of products will generally have the greatest impact (e.g. type and quality)
 - But, minor differences in contractual terms (e.g. volume) or economic conditions (e.g. level of market or geographic market) could have a significant impact too

Questions?



Thank you for your time and participation!



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