

Transfer Pricing: Policies to Revisit

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Transfer prices are the prices of goods, services, or intangible goods exchanged by the different national entities of the same corporation.

Since an intercompany transaction takes place between businesses that are affiliated within a group, the market mechanisms that are generally used to set prices between third parties may not apply. As the transfer pricing process determines the amount of income that each entity of the group earns from intercompany transactions, it is under the close scrutiny of governments and tax authorities alike. The latter carefully monitor the allocation of profits and losses to their jurisdiction.

The Organization for Economic Co-operation and Development's (OECD) "Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrators," first issued in 1979 and regularly updated and revised since then, have become internationally followed. They advocate the arm's length principle of treating related enterprises within a multinational group: A transfer price should be the same as if the entities of the group undertaking the transaction were independent (i.e., not part of the same corporate structure). They also affirm traditional transaction methods as the preferred way of implementing the principle.

What is at stake for tax authorities?

Cross-border transactions between foreign-affiliated parties of multinational corporations are increasingly important in today's business world. A considerable proportion of world trade takes place within the boundaries of multinational enterprises -- up to 60%, according to several sources.

In order to prevent profits from being systematically deviated to lower-tax countries or through abusively overestimated (or underestimated) transfer prices, tax authorities around the globe can and do adjust inter-company pricing if they think that the transfer price would differ from a price agreed between two unrelated (arm's length) parties.

Price adjustments made by tax authorities can have an adverse tax effect on the business entity, especially when combined with additional interest and tax penalties. In many cases, these result in the double taxation of the deviated profits.

A real activism around transfer pricing

In recent years tax authorities and governments have demonstrated considerable activism around the issue of transfer pricing. Many global developments evidenced this trend in 2008 alone. We should at least mention:

In the USA

- Cost sharing regulations were released (though the long-awaited final regulation on global dealing is expected to be released later in 2009);
- The United States Government Accountability Office delivered a report on “Tax Administration: Comparison of the Reported Tax Liabilities of Foreign- and US-Controlled Corporations”;
- The US Treasury’s Office of Tax Analysis released a working paper on “Income Shifting from Transfer Pricing: Further Evidence from Tax Return Data”;
- The IRS expanded the scope of issues that may be covered by an Advance Pricing Agreement (APA), including, notably, the attribution of profits to a permanent establishment.

In France

- The government released draft regulation on transfer pricing documentation that will become compulsory for large companies in 2010.

By the OECD

In 2008, the topic of transfer pricing was a priority on the OECD’s agenda. Important developments included:

- The final report on the allocation of profits to permanent establishments (PE report);
- A discussion draft on the transfer pricing aspect of business restructurings;
- A discussion draft on comparability and profit methods for transfer pricing purposes;
- Changes to Article 25 of the “OECD Model Tax Commentary,” on dispute resolution;
- A call for comments on a new draft Article 7 of the “OECD Model Tax Convention” and related commentary changes.

In light of these developments in transfer pricing regulation and guidance, vigilance on the part of multinational companies is strongly advised, as is a thorough review of transfer pricing policy.

Focus on financial institutions

Financial institutions’ concerted attention to transfer pricing policy and practices is necessary for the following reasons:

- In the first place, the PE report is mainly directed at them;
- Moreover, the current crisis has resulted in significant changes in their operational activities, which might affect transfer pricing methods.

The PE report is the result of ten years of discussion. It details the authorized OECD approach to attributing profits – as well as losses – to a permanent establishment (PE) of banks, enterprises that engage in the global trading of financial instruments, and insurance companies.

The OECD details a two-phase approach to determine the profits that would have been realized if the PE had been a separate and distinct enterprise engaged in the same or similar activities under the same or similar conditions and wholly independent of the rest of the enterprise.

The first phase consists of factual and functional analysis, which leads to:

- The attribution to the PE as appropriate of the rights and obligations arising out of transactions between the enterprise the PE belongs to and its separate enterprises;
- The identification of “significant people functions” (KERT: Key entrepreneurial risk-taking functions) relevant to the attribution of economic ownership of assets and of risks, and attribution of economic ownership of assets and of risks to the PE;
- The identification of other PE functions;
- The recognition and determination of the nature of those dealings between the PE and other entities of the same enterprise that can be appropriately recognized;
- The attribution of capital, based on the assets and risks attributed to the PE.

The second phase consists of the pricing at an arm’s length basis of recognized dealings through:

- The determination of comparability between dealings and uncontrolled transactions, established by directly applying the OECD guidelines’ comparability factors (such as the characteristics of property or services, specific economic circumstances, or business strategies) or by analogy (functional analysis, contractual terms) in light of the particular factual circumstances of the PE;
- Applying by analogy one of the guidelines’ traditional transaction methods or, where such methods cannot be applied reliably, one of the transactional profit methods, to arrive at an arm’s length compensation for the dealings between the PE and the rest of the enterprise. The functions performed by, and the assets and risks attributed to the PE are taken into account.

Does the financial crisis impact existing transfer pricing methods?

So far, in order to contain the impact of the financial crisis, many governments have taken a broad range of measures, from restructuring and recapitalizing financial services corporations to regulating the compensation of senior executives or traders. Besides, the institutions themselves have undertaken drastic plans to streamline their activities and refocus their development on core activities or customers.

All these measures, considered in light of transfer pricing methods and the arm’s length principle, raise many questions. For instance:

- For global trading operations that were terminated or transferred, losses should have been allocated in the same manner as profits would have been: was this really the case?
- Should transfer pricing methods based on the compensation of traders -- which is generally used as the key driver for allocation of income -- be adapted?
- Did intercompany financing reflect the credit spread changes?

The new guidance provided by the OECD, as well as significant changes in the market, should trigger a substantive review of transfer pricing policies within the financial industry.

Changing transfer pricing policy: not only for tax specialists

If transfer pricing is a central issue to tax risk management, the definition and implementation of a new policy requires a comprehensive approach by a business and the creation of a multidisciplinary team that should be part of this strategic project (Tax, Management Control, Accounting and Finance, Personnel and Marketing departments, Economists, Financial and Business Analysts, Project Managers...).

The objective of a transfer pricing policy is to secure transactions and avoid double taxation. For this, each multinational group should be able to provide the different tax authorities with thorough documentation of its transactions and explain how it has selected the most appropriate transfer pricing method.

The different steps of this assessment should, at the very least, include:

- A thorough analysis of the group, its scope and relations between entities (subsidiaries, PE) and of its transactions and products;
- A market study. Tax optimization is not the only driver of business, and the group should demonstrate that factors such as market opportunities, the size and extent of market competition, and economic conditions are the main drivers of business development;
- A factual and functional analysis (function performed, determination of KERT functions, resources employed in these functions, attribution of ownership, of risk, allocation of capital...);
- An economic analysis. This includes a comparability analysis of transfer pricing rules for each country in which the group does significant business; an economic study of local tax systems and local fiscal capacities; the selection of the transfer pricing method – and therefore the key drivers for attributing income; a comparability analysis of “uncontrolled transactions” in order to support selected methods;
- Tests of transfer pricing methods (simulations based on both historical results and activity forecasts; and an impact assessment study of the tax expense scenarios for each entity of a group);
- The implementation of a validated transfer pricing policy. This encompasses all of the components involved in the processes of collecting, reporting, and storing data: transaction records, profit and loss statements, pricing documents, third-party comparable transactions data, ownership and capital structure records...;
- Formalization of transfer pricing documentation and preparation for the negotiation of Advanced Pricing Agreements.

Whatever the type of diversification (vertical, horizontal, geographical, or in terms of product variety), the more diversified a group's business is, the more complex a transfer pricing policy's implementation becomes. Therefore informed and strategic project management becomes all the more important.