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Transfer Pricing

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Developing a Global Transfer Pricing Strategy

What is transfer pricing?

The operating units of multinational corporations usually engage in a variety of inter-company transactions. A key issue of international taxation is “transfer pricing.” The term refers to the pricing of goods and services transferred between related persons not dealing at “arm’s length.”

What is “arm’s length”?

Prices charged after bargaining between unrelated persons are called “arm’s length” prices. When unrelated parties deal at arm’s length, the prices at which they transact reflect both prevailing competitive conditions and the specific course of bargaining between them. Among related persons transfer prices answer to no economic pressure. They may reflect a largely unconstrained decision by the parties to adjust accounts among themselves. Transfer prices affect the distribution but not the absolute amount of gain or loss among related persons. If entities within a related group face different tax environments or different rates of taxation, transfer pricing may bear decisively on tax consequences. Departure from arm’s length prices between affiliates organized in different countries may shift taxable income to a low-tax environment and deductible expense to a high-tax one.

Transfer Pricing Then.....and Now

In the very recent past, transfer pricing was almost exclusively the domain of economists and a few large companies with complex global organizations. Times have changed. With companies continuing to realign supply chains and move production to lower cost countries, international transactions involving goods, services and the licensing of intangibles have become commonplace, with many transactions taking place between related entities. In this environment, the location of profits for tax purposes can have a dramatic effect on a company’s consolidated financial and tax position. Coordination of transfer pricing with overall

tax strategies has evolved to become one of the top tax issues facing multinational companies.

Transfer pricing will be center stage in the next few years as countries reduce their corporate tax rates to remain competitive in the global economy. What countries cannot legislate directly, they will pursue through transfer pricing. As more multinationals seek to drive performance improvements and reduce effective tax rates, they will need to support effective, sustainable transfer pricing strategies to succeed.

What is my risk?

The risk associated with non-compliance with transfer pricing rules can be substantial. Adjustments and penalties, and interest on those amounts, can be severe. Tax authorities are becoming more aggressive in making transfer pricing adjustments on examination. In 1995, only three countries had developed transfer pricing regimes – Australia, South Africa and the United States. By 2007, almost 40 countries had developed transfer pricing regimes. Transfer pricing is a tier one audit issue in the United States. If a company is under examination, the transfer pricing policy will likely be examined.

How do I avoid penalties?

To avoid the penalty provisions, a taxpayer must prepare and document a well-reasoned analysis demonstrating why it chose a particular transfer pricing methodology, why it applied the methodology, and the manner in which it used third-party data to support the arm’s length result. In the US, the IRS and the taxpayer may disagree on the appropriate transfer pricing method or the proper application of data so that a taxpayer is subject to an adjustment, if the taxpayer has adequately documented its methodology, it may nevertheless avoid penalties.

Contemporaneous documentation provides protection in most developed countries from a transfer pricing penalty, but the documentation required varies by country. The task of meeting the requirements for multiple countries can be daunting.

Developing a Transfer Pricing Strategy/Study

In the current environment transfer pricing strategy is driven, to a great extent, by the need to develop an effective defense against adjustments and penalties. The first step in developing a defense against these penalties is to access the amount of risk associated with the company's current position. One major determinant of risk is the aggregate dollar value of controlled transactions between US and foreign affiliates. Another major determinant of risk is the relative profitability of US and foreign operations.

The proper analysis of transfer pricing is largely unrelated to the tax law. The overriding question is "How would independent parties have dealt with each other?" This is not a tax or legal question but, rather, a business question. It is integrally tied to the business activities of both parties involved in the inter-company transaction. Therefore, it is important to begin any analysis of transfer pricing issues with an analysis of the "business" in which the transactions occur.

Transfer pricing analysis is, fundamentally, "value chain analysis." In other words, it is designed to examine each element in the chain, starting with R&D, proceeding to manufacturing, marketing, sales and, if applicable, ending with after-sale service to the end-user of the product. The overall question is, "What are the value drivers in the business?" In other words, what makes this product successful in its market?

The question that must always be answered is, "Which legal entity is the 'entrepreneur'?" In general, it is the owner of the significant intangibles involved in the transaction, and it is usually the legal entity that makes the key strategic decisions (e.g., product decisions, marketing strategy, etc.). The "entrepreneur" is the entity that takes the risks in the market and reaps the rewards, either positive or negative. All other legal entities are entitled to a "reasonable" return for the functions they perform and for the risks they bear. The entrepreneur gets the residual profit or loss generated by the transaction.

Steps to a Transfer Pricing Policy

1. *Identify and organize the company's transactions*
2. *Obtain financial data and develop financial models for the transactions to be studied*
3. *Perform functional analysis and characterization of entities*
4. *Analyze inter-company transfers of intangible assets*
5. *Analyze inter-company transfers of tangible assets*
6. *Perform an analysis of services connected with transfers of intangibles*
7. *Perform an analysis of services connected with transfers of tangible property*
8. *Analyze services that benefit the recipient*
9. *Test the policy*
10. *Maintain documentation – In the US principal documents must be maintained by the taxpayer and must be in existence with respect to a given tax year at the time the return for the year is filed. Certain other jurisdictions require the documentation to be filed with the tax return.*

Please be advised that, based on current IRS rules and standards, any U.S. tax advice contained in this booklet was not intended or written to be used, and cannot be used, by the recipient for the purpose of avoiding penalties that may be imposed under the Internal Revenue Code or applicable state or local tax law provisions.

