CLARK SCHAEFER HACKETT
CPAs & BUSINESS CONSULTANTS

DUFF & PHELPS

Transfer Pricing for Middle Market Companies

May 16 , 2014

Dan Fales
CSH

Michelle Johnson
D&P

Lisa Wineland
CSH

Ryan Lange
D&P

Discussion Outline

I. Introduction to Transfer Pricing

II. Risk and Opportunities in Transfer Pricing

III. Today's Audit Environment

IV. Transfer Pricing Recommendations

V. Key Takeaways

VI. Questions and Resources

Section I

Introduction to Transfer Pricing

What is Transfer Pricing?

- Establishing the price charged for transactions between related entities located in different taxable jurisdictions
  - Sales of Tangible Property
  - Transfer of Intangible Property
  - Provision of Services
  - Loans/Guarantees

- The transfer price establishes the division of profits between two related entities and their respective taxing jurisdictions (i.e., taxable income).

- Transfer price is an “internal” price, not a “market” price.
  - Transfer pricing rules provide a way to determine market prices for non-market transactions.

- The Arm’s Length Standard is the fundamental basis of most worldwide transfer pricing regulations.
  - The arm’s length standard is accepted by most developed and many developing nations for intercompany transfers of goods, services, intangibles and various financing transactions.

Global Transfer Pricing Landscape

Tax Priorities through recent surveys to executives of multinational corporations.

73% of Multinationals have seen a rise in frequency of tax audits, and felt an increased focus on substance from tax authorities. Increases to 100% for those surveyed in the Americas.[1]

Transfer Pricing is listed as the tax area which has received the most scrutiny from authorities. [1]

70% of multinationals do not have a complete overview of the intangibles in the business; 33% have been subject to an intangibles tax audit, of which 40% received a transfer pricing reassessment. [2]

60% of multinationals subject to interest charge from a TP adjustment; 24% subject to penalties.[3]

1 Taxand, 2014 Global Survey, www.taxand.com/sites/default/files/taxand/documents/Taxand%20Global%20Survey%202014.pdf
2 Taxand, 2013 Global Intangibles Survey, www.taxand.com/sites/default/files/taxand/documents/axand_Global_Intangibles_Report_2013_-_FINAL.pdf
3 Ernst and Young, 2013 Global Transfer Pricing Survey, www.ey.com/GL/en/Services/Tax/2013-Global-Transfer-Pricing-Survey.

Common Transfer Pricing Misconceptions

- “Taxing authorities are focused on only the largest multinational companies.”
- “I don’t have any Tier 1 Issues so I am in the clear for transfer pricing audits.”
- “Transfer pricing compliance is too expensive.”
- “All my foreign affiliates are ‘flow-through’ entities so I don’t have to worry about transfer pricing.”
- “I have NOLs in the US so the IRS doesn’t care about my transfer pricing.”

Impact of Transfer Pricing

What does this mean for Middle-Market Companies?

"Maruca explained that **the road map consists of audit guidelines for effective case selection and development**…a guideline for developing transfer pricing cases, **directed mostly at the middle market…to develop "more of a footprint" in the middle market , where issues of routine fact patterns are more common**."

Samuel Maruca (IRS Transfer Pricing Director) Comments – Accessed through BNA Article "IRS to Kick-Off Transfer Pricing Practice with Presentation of 'Road Map' for Cases"

"I also want [the IRS] to **move more deeply into the mid-market** – those firms and partnerships between $10 and $250 million in assets. Up to now, our presence in the mid-market – **where we currently have about 11.9% coverage** – hasn't been as robust as we would like it to be. **But I believe many mid-market corporations may have the same issues as larger entities and perhaps additional issues as well**."

Remarks of Steven T. Miller, IRS Deputy Commissioner – March 2012

"While it has taken a number of years, HMRC is now broadly satisfied that the largest businesses are conforming to transfer pricing regulations. The **mid-tier are next in line to be investigated**, and should make compliance a priority **immediately…mid-tier businesses…are now firmly on HMRC's radar.**"

Remarks of Heather Self, Corporate Tax Expert – February 2014

Section II

Risks and Opportunities in Transfer Pricing

Global Transfer Pricing Landscape

Countries Adopting Documentation and/or Penalty Rules[1]

1994 - 2000

United States
Australia
France
Mexico
Brasil
Canada
South Korea
United Kingdom
Denmark
Venezuela
South Africa
Germany
Belgium
Argentina

2001 - 2007

Japan
Poland
Kazakhistan
India
Portugal
Colombia
Netherlands
Thailand
Malaysia
Indonesia
Norway
New Zealand
Peru
Spain
Taiwan
Hungary
Lithuania
Ecuador
Vietnam
Singapore
Sweden
Israel
Finland
Estonia

2008 - 2013

Greece
Turkey
China
Austria
Azerbaijan
Bulgaria
Chile
Croatia
Czech Republic
Egypt
Georgia
Hong Kong
Iceland
Italy
Latvia
Luxembourg
Moldova
Romania
Russia
Slovakia
Slovenia
Switzerland
Uruguay
Uzbekistan
Dominican Republic
El Salvador
Ghana
Guatemala
Kenya
Nigeria
Panama
Philippines
Qatar
Uganda

2014 - Onward

Predicted Regions where Transfer Pricing Requirements/Penalty Rules will be introduced:

- **Central America**
- **Sub-Sahara Africa**
- **Other?**

1 Countries adopting transfer pricing rules were compiled utilizing 2013 Global Country Guides from Deloitte (www.deloitte.com), KPMG (www.kpmg.com), and Ernst and Young (www.ey.com)

Country Requirements Matrix

Below are highlights of transfer pricing requirements for selected countries

Country	Documentation Preparation Date	Documentation Due Date	Penalty Relief	Transfer Pricing Penalties	Documentation Language	Transfer Pricing Audit Risk
United States	Annual Tax Return Submission	30 – 60 Days of Request	Yes	20% - 40% of Tax Adjustment	English	High
Mexico	Annual Tax Return Submission	Immediately upon Request	Yes	40% - 75% of Tax Adjustment	Spanish	High
Germany	Annual Tax Return Submission	30 – 60 Days of Request	No	5% - 10% of Adjustment	English or German	High
Canada	Annual Tax Return Submission	90 Days of Request	Yes	10% of Adjustment	English or French	High
India	Annual Tax Return Submission	Specified in Audit Notice	Yes	>2% of Transaction + Addl fees	English	High
United Kingdom	Annual Tax Return Submission	30 Days of Request	Yes	30% -100% of Tax Adjustment	English	High
China	Annual Tax Return Submission	20 Days of Request	Yes	Interest + 5% + Addl Fixed Fees	Chinese	High
Brazil	Annual Tax Return Submission	20 Days of Request	No	25% - 225% of omitted taxes	Portuguese	High

Countries That Pose Transfer Pricing Difficulties

Example: Brazil

- Brazil first introduced transfer pricing regulations in 1996; however they openly do not follow the Arm's Length Standard. The Brazilian regulations generally follow a formulaic, fixed margin approach.
  - For example, under the "Resale Price Method", a general markup of 20% is required on imported product, except with respect to certain specified industries to which a markup of 30% or 40% must be applied.

- In addition to its formulaic approach to transfer pricing, Brazilian law imposes restrictions on royalties that can be charged for the use of intellectual property, among other unique provisions.
  - License and transfer agreements for patents, non-patented technology, technical assistance services, industrial design, and trademarks must be recorded with, and approved by, the Brazilian Patent and Trademark Office.

Countries That Pose Transfer Pricing Difficulties (continued)

Example: China

- The State Administration of Taxation ("SAT") released the current transfer pricing rules in their final form in 2009.

- China has openly revealed its views and practices on a number of transfer pricing issues which pose challenges for multi-national companies operating in China including:
  - Deductibility of service charges
  - Lack of reliable Non-Chinese comparables (and subsequent adjustments)
  - Use of secret comparables
  - Location Specific Advantages ("LSAs")

What if Transfer Prices are Wrong?

Tax Penalties	▪ There is an increased risk that penalties will be assessed for incorrect (i.e., non-arm's length) transfer pricing. ▪ Penalties under Section 6662 range from 20% to 40% (in the case of substantial and gross valuation misstatements, respectively) addition-to-tax penalties on the portion of underpayment of tax attributable to accuracy related penalties.
Misalignment of Customs Valuations	▪ New Customs Rules harmonize customs and transfer pricing allowing the recognition of post-importation pricing adjustments.
Financial Performance	▪ Difficult to capture the true financial performance of group members which can result in bad management decisions and erroneous incentives.
ASC 740 (FIN 48)	▪ Incorrect Transfer Pricing leads to ASC 740 (FIN 48) reserves
Double Taxation	▪ There exists a risk of double taxation upon adjustment. ▪ Competent Authority relief is only available for countries where a treaty exists.
Litigation	▪ Incorrect Transfer Pricing can lead to US and/or Non-US Litigation. ▪ Transfer pricing litigation can be a long, drawn-out and often costly process.

Benefits of Good Transfer Pricing

Tax Savings	▪ Proactively managing a global transfer pricing structure allows for the efficient placement/movement of functions, assets and risks within a company's value chain which can result in significant tax savings.
Cash Planning	▪ Transfer Pricing can be an effective mechanism to move cash where it is needed. ▪ Effective transfer pricing planning can preclude the need for internal/external financing saving on interest expenses.
Risk Mitigation	▪ Reduces ASC 740 (FIN 48) Reserves ▪ Reduces exposure to documentation-related penalties ▪ Reduces risk of transfer pricing adjustments and subsequent double taxation

Section III

Today's Audit Environment

Today's Audit Environment

Transfer Pricing Audits are increasing in Significance, Intrusiveness, and Scope

- Service, intangible and financing transactions are increasingly the focus of tax authorities
- Tax authorities are discussing and exchanging information on taxpayers
- IRS is expanding efforts to focus on middle market clients
- Emerging markets are coming to the forefront of audit activity (e.g., India and China)
- Advanced markets are increasing their audits (e.g., Canada)
- Authority Personnel are gaining more knowledge on transfer pricing triggers.
- Audit trends reveal the need for global transfer pricing policy and documentation analysis

Key Audit Triggers

- Operating losses for a several year period
- Low or variable profit trends
- Transactions with tax havens
- Intangible-related transactions (especially involving the transfer of intangibles)
- Presence of foreign disclosure forms in return
- Cost Sharing
- Financing Transactions
- Business restructurings (risk shifting)
- Service Charges
- Aggressive tax structures and/or complex entity structures
- Discrepancy between TP documentation, local country GAAP and/or tax filings
- Lack of documentation

Questions Being Asked by Tax Authorities

Question	Motive
Prove benefits align with service charges	With no proof, they are denied
Provide the GL of the Headquarter company and illustrate how the cost pools align to the intercompany services charged	If not fully loaded, then potentially not arm's length
Focus on key service charges such as IT, Marketing, Advertising, Engineering, R&D and Legal	These services typically generate IP and payor may own intangibles
Show comparisons of actual prices charged vs. pricing terms in your intercompany agreements vs. prices supported by your transfer pricing studies	If work papers are inconsistent, then adjustment should be evaluated
What written and verbal guarantees are provided	If no analysis performed, then adjustment is calculated
Supply your transfer pricing reports prepared for other side of the transaction (i.e., in the other country)	If reports are inconsistent, then potential adjustment

Section IV

Transfer Pricing for Middle Market Companies

Transfer Pricing Issues for Middle Market Companies

- Finance and tax departments have numerous responsibilities and may not have the luxury of focusing on transfer pricing
- Costs of extensive documentation in every country may not be worth the benefits
- This leaves many companies stuck with
  - Little or no transfer pricing support
  - Legacy transfer pricing policies that are not arm's length
  - Mismatch of substance and form for intercompany transactions
  - Poor integration of acquisitions/inability to conduct proper due diligence

Efficient Documentation Strategies

Approach	Description	Pros	Cons
No Documentation	Do not prepare any analysis or support (i.e., the "wait and see approach")	• Cost and time efficient	• No penalty protection • Costly to complete if TP documentation is requested • Completely exposed ; tax authority get to tell its story first
Simple Benchmarking Analysis or TP Memoranda	Preparation of only economic support; or Preparation of a "bare bones" transfer pricing analysis.	▪ Cost efficient way to assess and mitigate risk (including ASC 740/FIN 48 reserves) ▪ Addresses the primary aspect of TP documentation (i.e., economic support)	▪ Does not explicitly meet local country documentation requirements (but generally accepted by auditors)
OECD Policy Report	Prepare a single standardized document that is relevant for multiple/all group members that can be supplemented by country-specific data	▪ Often successful in preventing adjustments (and therefore any penalties tied to such adjustments) ▪ Covers risks of many countries in single document (great for ASC 740/FIN 48 reserve minimization)	▪ First line of defense—may need to further customize to local country format requirements, but can wait until audited to decide (more control) ▪ Higher initial costs than simple benchmarking, but with the added benefit of laying out fact pattern
Country-Specific Documentation	Prepare separate and unique documentation packages for each country of operation	▪ Comprehensive, country specific transfer pricing documentation ▪ Provides penalty protection	▪ Annual compliance costs are high ▪ Benefit may exceed costs only for most material countries/transactions

Section V

Key Takeaways

Key Takeaways

- IRS expanding transfer pricing audits to middle market
- Now is the time to revisit your transfer pricing
- Foreign owned companies need to emphasize U.S. transfer pricing risk to foreign owners
- U.S. entities with disregarded entities need to look at local country transfer pricing
- Perform a cost/benefit analysis and ensure proper documentation is on hand

Section VI

Questions and Resources

Questions

Questions on Transfer Pricing?

Let’s Hear it.

Transfer Pricing Resources – Contact Information

Michelle Johnson – Managing Director

(p) 312.697.4680

(e) michelle.johnson@duffandphelps.com

Michelle has significant experience advising clients on transfer pricing and valuation matters, including transfer pricing documentation preparation, ASC 740 (FIN 48) recognition and measurement analyses, advanced pricing agreements, cost-sharing analyses, buy-in valuations, supply chain restructuring and tangible and intangible transfer pricing policy development. Michelle has assisted numerous clients on revamping their documentation and compliance processes to become more efficient and effective given today's global audit practices. In addition, Michelle has significant experience managing local teams across the globe to harmonize companies' transfer pricing policies and coordinate global documentation in numerous countries.

Michelle led the development of Duff & Phelps' ASC 740 (FIN 48) service line for transfer pricing and pioneered several thought leadership publications. She is an award-winning speaker and has presented at numerous conferences and seminars regarding transfer pricing issues. She served as co-editor of Wolter Kluwer's Guide to International Transfer Pricing: Law, Compliance and Tax Planning Strategies, and co-authored the BNA Tax Management Portfolio on ASC 740-10 (FIN 48) (published 2012). Michelle also oversaw Ceteris' transfer pricing team's US operations and was responsible for quality and training of the company's US transfer pricing practice. Earlier in her career, Michelle was part of Ernst & Young's transfer pricing practice, having spent time in the company's Chicago, San Jose and New York offices.

Michelle obtained her Masters degree in Economics from New York University and a BS in Economics and French from the University of Illinois.

Transfer Pricing Resources – Contact Information

Ryan Lange – Director

(p) 312.697.4786

(e) ryan.lange@duffandphelps.com

Ryan Lange joined Duff & Phelps in 2012. As a director, Ryan advises clients' senior management teams on a variety of issues related to transfer pricing, economics and valuation. Throughout his career, Ryan has supported and managed large litigation support projects, prepared US, OECD and local country transfer pricing documentation, assisted in the design and preparation of economic planning and global policy projects, advised on intellectual property valuation issues, and analyzed complex transfer pricing issues in compliance and controversy contexts. He has significant experience conducting functional, risk, comparable company and economic analyses in a broad range of industries – including consumer goods, education, medical products, pharmaceutical, e-commerce, automotive, telecommunications, financial services, real estate, software, energy, and industrial goods.

Ryan previously worked for Ceteris. Prior to that, he was an analyst in the Business Financial Services division of Merrill Lynch. Ryan has a Bachelor of Business and Administration in Finance, Investment and Banking and a Bachelor of Business and Administration in Real Estate and Urban Economics from the University of Wisconsin-Madison.

Transfer Pricing Resources – Contact Information

Dan Fales, Shareholder

(p) 513.241.3111

(e) dfales@cshco.com

Daniel Fales works with clients on both inbound and outbound international issues. He has been involved in transactional matters including international restructurings, mergers, acquisitions, and financings. He works with U.S. companies as they make their first forays into international operations and provides clients with tax favorable structures for international expansion. He also works with clients on understanding the international tax compliance regime and international tax reporting. Dan is his clients' trusted advisor on transfer pricing documentation requirements.

Dan serves as the primary advisor to the shareholders and owners of various closely-held and family-owned businesses, providing counsel on their global and US-based income, estate taxes, and succession planning. When his clients are multinational taxpayers, or executives with overseas assignments, Dan has the specialization to plan strategies that minimize their potential tax liabilities.

Education:
BS, Accounting & Business Administration, Washington & Lee University
JD, University of Dayton School of Law

Certification & Licensure:
CPA – State of Ohio
Federal District Court, Southern District of Ohio
US Tax Court

Transfer Pricing Resources – Contact Information

Lisa Wineland, Principal

(p) 513.241.3111

(e) lwineland@cshco.com

Lisa Wineland specializes in the area of international and corporate taxation. She consults with clients regarding international outbound and inbound transactions as well as entity structure planning. She serves many multi-national clients with international reporting requirements. Prior to joining the firm Lisa spent many years with a Big Four accounting firm and most recently worked in private industry for a Fortune 20 multi-national public company. Her international experience includes cross-border transaction analysis, foreign tax credit planning and compliance, M&A transactions, and related party tax reporting.

Education:
BSBA, Accounting, Ohio University
MBA, Finance, Franklin University

Certification & Licensure:
CPA – State of Ohio

Thank you!

Transfer Pricing for Middle Market Companies

May 16 , 2014

Dan Fales
CSH

Michelle Johnson
D&P

Lisa Wineland
CSH

Ryan Lange
D&P