Tax Services Transfer Pricing

Transfer Pricing in a recession

What companies should consider

The United States represents approximately 20 percent of the global economy, and the impact of the continuing U.S. economic crisis is being felt globally.

The housing market correction (with substantially reduced home values) in the United States and the collapse of the subprime mortgage market have pushed up credit costs worldwide and forced U.S., European, and Asian banks to write down billions of dollars in holdings or, in some cases, file for bankruptcy. The credit crisis has brought reduced liquidity in the U.S. and global markets and U.S. stock prices have dragged down markets in Europe, Japan, and China, among others.

Reduced liquidity, downward pressure on the stock markets, inflationary pressure in commodities, and rising unemployment have further reduced investment, consumer demand, and production. It is yet to be seen whether and when the response of central banks and governments to ease monetary conditions reducing interest rates, lending money to companies, and infusing cash into global economies will work.

In certain industries, multinational companies are experiencing significant operating losses. These losses cut across geographies and total hundreds of millions, if not billions, of dollars. The United States is officially in a recession, but the U.S. economy has been slowing down for some time. The recession certainly will affect transfer pricing—but how?

Tax authorities' response

With rising unemployment comes reduced personal income taxes, and with reduced corporate profits come reduced corporate revenue. The global tax base has decreased and probably will continue to shrink. Even in a recession, a discussion by any politician of increased taxes is risky. More money is needed to keep funding current programs, and while taxes of many varieties may increase, a less controversial option is for the Internal Revenue Service to collect more revenue through increased enforcement and other means.

Globally, taxing authorities will increase their efforts to collect taxes needed to fuel their governments' spending. A substantial increase in tax audits, including those focused on transfer pricing, is expected. In addition to the increased number of audits expected globally, the difficulty and complexity of such audits are expected to increase as taxing authorities continue to become more sophisticated and open to sharing taxpayer information. Issues that may have been overlooked before will be reconsidered. Settlement positions arrived at in the past may no longer be accepted. All possibilities are on the table.

Reduced profits, increased enforcement

In such uncertain economic times, how should multinational companies approach defending past transfer pricing policies including those established under advance pricing agreements during robust economic times? How should companies prepare to go forward regarding their transfer pricing options?

In addition to ensuring they have adequately documented their transfer pricing to defend historical positions, companies also must consider ways to optimize current and future transfer pricing positions. This includes evaluating current transfer prices under current structures as well as opportunities to modify current organizational and tax structures. Multinational companies' abilities to develop and sustain tax-efficient structures (alongside required supply chain modifications) will have significant implications for their abilities to reduce costs and remain competitive.

Defending historical positions

Documentation that supports a taxpayer's historical transfer pricing position typically includes the conclusions of a functional analysis as well as economic analysis. The functional analysis defines the characterization of a tested party.[1] It evaluates a taxpayer's intercompany transactions through isolating the functions performed, risks assumed, and assets owned and employed by all of the counterparties to the tested intercompany transaction. Some example categories of characterization include a service provider, a buy-sell entity such as a distributor, a contract manufacturer, or an entrepreneur. Having conducted a detailed functional analysis and determined the characterization of the tested party, it is then possible to identify the best method for testing the transaction.

If the best method is a profit-based transfer pricing method such as the comparable profits method under U.S. transfer pricing regulations or the transactional net margin method under transfer pricing guidelines set by the Organization for Economic Cooperation and Development, one looks to identify companies performing comparable activities to those of a tested party in benchmarking the profits that it should have earned during years under analysis. In applying CPM, the time horizon tested is conventionally three years.[2] typically the three years prior to the year under analysis due to the time lag in publicly available financial data for comparable companies.

Therefore, a company preparing transfer pricing documentation for 2008 most likely will be using comparable data from 2005 through 2007 for U.S. data and 2004 through 2006 for foreign data (because there is a longer time lag in information availability outside the United States).

In a recessionary economy, this time lag in comparable data will affect the way in which taxpayers and transfer pricing practitioners approach benchmarking and justify historical positions.

Select comparables wisely

When applying CPM or TNMM, consider the business cycle of the tested party in searching for comparable companies. Business cycles vary, and not all industries follow the same cycle. One example during a recession can be found in the luxury goods industry. This industry typically fares poorly while the health care industry, including the pharmaceutical industry, may fare better.

While searching for functionally comparable companies to benchmark appropriate returns for a service company, look more closely for industries with similar business cycles. Companies in certain industries feel the effects of a recession sooner than others, and certain companies take longer to recover from a recession. This may create a serious mismatch in the comparability of the tested party and the comparable companies. Taxpayers may find that service companies facing real market risk in a particular industry show considerably reduced profits or, in fact, experience losses over a few years of a given business cycle. Therefore, thought should be given as to whether loss companies should be included or rejected from a set of comparable companies (to reflect true economic cycles).

Oftentimes, benchmarking studies automatically eliminate loss-making companies as a way to limit a sample. The compulsory elimination of loss companies (while including extremely profitable companies) tends to upwardly distort a benchmarking. In fact, in a recessionary environment, it may be particularly appropriate to include loss comparables in certain industry segments. Companies should be selected through the benchmarking process on the basis of functional comparability, regardless of their profit margin.[3]

[1] **Source:** The entity that engages in the intercompany transaction being tested.
[2] **Source:** This can be a longer time period depending on the fact pattern. In some countries five years is more consistently used.
[3] **Source:** The margin may be used as a flag to help identify when to further review a potential comparable, but wholesale elimination of loss makers is likely inappropriate, particularly in a slow economy.

When looking to apply transactional methods, such as the comparable uncontrolled transaction method, and neither internal nor external comparables exist, taxpayers should consider gathering other potential transactions or observations that may serve as supporting information for the taxpayer's position. That is, certain potential transactions may not be "sufficiently comparable" to satisfy the CUT method but they may provide valuable information on market pricing practices in a given industry, such as contractual terms indicating how parties have agreed to modify prices under certain circumstances, discounts offered, and how to deal with obsolete inventory under a distribution contract.

Time period reviewed

In addition to focusing on particular industries, consider the time horizon applied in any analysis to best represent the full business cycle capturing the times of high profits as well as low profits or losses. Instead of applying the conventional three to five years of analysis, consider an expanded period based on the cycles of the particular industry examined.

Regardless of how long a time period is reviewed, comparable data will lag the tested party by one or two years. Taxpayers can either simply accept the timing differences or consider other strategies. In a recession, that could frequently mean that the comparable data may show profits that are no longer arm's length in the period being documented, given a shift in the economy. Serious dislocations can occur in a recessionary economy, particularly in measuring and comparing profits and losses among participants in different industries.

Placement in the range

In the United States, when applying CPM or TNMM, any observation within the interquartile range of comparable companies will be considered arm's length.[4] Taxpayers may consider whether the data lag in the comparables means a different point within the range should be considered that better reflects the conditions of the year under review. In fact, recessionary times may dictate that arm's-length results are reflected over a broader range of observations.

Loss splits?

Companies that have been applying profit split methods will have added difficulty determining how to split losses, although the fundamental principles of splitting profits versus splitting losses may remain the same.

Faced with overall system losses, the ability to modify approaches to benchmarking for "routine" activities becomes heightened, shifting particular focus to the types of risks assumed by group entities. Service providers may be benchmarked to be earning losses in certain years or earning lowered markups on costs than in robust economic times. Remaining system losses may be appropriately split according to material system risks as well as ownership of valuable property (for example, intellectual property) and strategic management or key decision-making functions. That is, considering which legal entities have decision-making control over certain cost-reduction efforts (for example, eliminating product lines), as well as the entities benefiting from the decision made will influence the determination of who should bear related losses. Needless to say, focusing on the salient facts driving profits in good times and losses in bad times will be key to supporting the split of profit or losses determined.

[4] **Source:** In certain countries, any observation within the full range is considered to be arm's length, which may allow more flexibility to the taxpayer. However, many times the selection of comparables is more restrictive which can negate the effect of using the whole range.

Complying with existing APAs

Complying with existing APAs, which were established during robust economies, may prove financially challenging. That is, generally such APAs will require application of a transfer pricing method and comparables that represent healthy financial results for the tested party, and they may no longer reflect arm's-length results.

In such circumstances, taxpayers may consider whether it is possible to opt out of an APA, taking their chances on supporting profit results lower than those agreed to through transfer pricing documentation and robust economic analyses. Alternatively, taxpayers may attempt to revise an APA with the relevant taxing authorities.

For U.S. purposes, taxpayers, for example, may determine whether any of the critical assumptions of an APA have been violated, warranting revision of the APA. A critical assumption is any fact (whether or not within the control of the taxpayer) related to the taxpayer, a third party, an industry, or business and economic conditions, the continued existence of which is material to the taxpayer's proposed transfer pricing method.[5] A standard critical assumption for U.S. purposes is that the business activities, functions performed, risks assumed, assets employed, and financial and tax accounting methods and classifications in relation to the covered (intercompany) transactions will remain materially the same throughout the term of the APA. Typically, a mere change in business (financial) results will not be a material change. Therefore, it is the taxpayer who must demonstrate that a material change to the business activities, rather than a mere change in business results, occurred. It should be noted that if a violation of an APA's critical assumption occurs and the taxpayer and IRS are unable to agree to revise the APA, the IRS may seek to cancel the APA.

Negotiating new APAs

In negotiating a new APA (or revising an existing APA) during economic downturns, taxpayers should consider the strategies discussed above to incorporate transfer pricing methods and results (for example, based on comparable benchmark companies) that are palatable to the taxpayer.

In addition to those strategies, taxpayers should consider other strategies that build in flexibility to the APA process. For example, consider shortened APA terms such as one to two years instead of the typical five-year APA term (including one rollback year, the current year, and three future years) allowing for quicker renewal periods. Taxpayers also should consider including special critical assumptions that incorporate triggers to cancel or amend the APA or to move from one method to another (a graduated method approach). Such triggers could include revenue targets, capacity utilization targets, or certain market conditions relevant to the taxpayer's industry or market.

[5] **Source:** IRS Rev. Proc. 2006-9, 2006-1 C.B. 278, Section 4.05, http://www.irs.gov/irb/2006-02_IRB/ar12.html (14 Transfer Pricing Report 676, 12/21/05). See also the IRS Announcement and Report Concerning Advance Pricing Agreements for calendar year 2007 (Announcement 2008-27), page 24, http://www.irs.gov/pub/irs-drop/a-08-27.pdf (16 Transfer Pricing Report 873, 4/10/08).

Additional considerations

During these difficult economic times, companies will be restructuring to deal with lowered sales from reduced market demand and looking to reduce costs and increase overall operational and tax efficiency. Functions and risks may be transferred to principals in tax-advantaged locations, intellectual property may be codeveloped by regional principals, or regional service centers may be established to support a taxpayer's structure more efficiently. Such activities will impact intercompany transaction—increasing some, reducing others—and taxpayers will need to actively manage their approach to transfer pricing and related documentation. With increased transfer pricing regulations related to restructuring in the United States and OECD countries, thoughtful consideration must be given to compensation required for intercompany transfers. Furthermore, intercompany transfers must have business purposes (outside of minimizing taxes) and economic substance to be respected and it is more important than ever that intercompany agreements support the actions, not just the intentions, of the related counterparties. It is also critically important that the actual operations match the corporate and transactional structures.

Transfer pricing policies with built-in flexibility are advantageous in turbulent economies, providing ease in moving from one transfer pricing method to another or in moving within given pricing ranges based on built-in triggers. For example, a royalty rate might vary depending on the results of a given year as opposed to being a fixed percentage of sales. This builds into the system a certain flexibility to have royalties that increase when the profits generated by the licensed intellectual property increase. However, taxpayers should recognize that flexible or fluctuating royalties, particularly where a decrease in royalties is observed, will not necessarily be viewed favorably by the tax authorities in the intellectual property holder's jurisdiction.

Taxpayers are urged not to simply be reactive to the current environment, but to consider more broadly the impact of any changes. Modifying policies and structures to, for example, utilize losses may seem advantageous today; however, companies should consider whether such a structure or policy would be as tax-efficient once larger profits are realized. For example, when considering the application of a profit split model, in loss-making years the sharing of losses may be viewed as more beneficial than having one entity bear the full burden of the losses. However, in times of greater profitability, these profits also will be split between the entities entering into the profit split, which may not be as advantageous from a tax perspective. In addition, a cost sharing arrangement may initially appear as a suitable method in which to share costs among many parties; however, when considered in more depth, such an application may be significantly more complicated, especially when considering cost sharing for existing intellectual property buy-in payments or ongoing royalties to the current intellectual property owner may be required.

Taxpayers also should ensure that they have sufficiently robust support for any change applied and that this support is carefully documented for defense in the future. Care should be taken to document the support for modifying a company's transfer price, and such modification must have the appropriate business case and economic substance.

Conclusion

The current downturn in global economies will bring reduced personal income and corporate profits (and potentially significant corporate losses), pressuring taxing authorities worldwide to become more aggressive in collecting tax revenue necessary to support their governments' needs. Global transfer pricing disputes are expected to rise, and multinational companies should be prepared to defend historical intercompany pricing policies and results through thoughtful approaches to applying both profit-based and transaction-based transfer pricing methods. The importance of well-documented transfer pricing policies and results of intercompany transactions will increase.

In looking to the future and learning from the past it will behoove taxpayers to consider building flexibility into transfer pricing policies through intercompany contracts and APAs that incorporate triggers to modify pricing policies and allow for revisions of such agreements with related parties and taxing authorities.

In this economy, taxpayers might consider a variety of ways to modify their transfer prices. Flexible royalties, profit splits, consideration of potential "loss comparables," modification of the number of years analyzed, and even targeting a different position in the range may be beneficial. In addition, companies may use the economy as a reason to consider supply chain modifications, intangibles migration, or cost sharing. Regardless of the choices made, care should be taken to ensure the transfer pricing is supported by the facts and that any modifications have been made in an arm's-length manner.

In these uncertain times, one thing is sure: When there is less money in the system, we can expect tax authorities to review all transfer pricing policies in earnest, especially if modifications have been made. Proper defense of these situations will be critical in the months and years ahead.

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