Transfer Pricing Today- Where Tax Meets Business Case Study Illustration

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Robert G. Rinninsland
The Ruchelman Law Firm

Transfer Pricing-Tax/Business Considerations and Analytical Pressure Points

- Business Models, Forecasts, and Strategies
  - Matrix vs. profit center business structure
- Benchmarking-Industry and Transactional Aspects
- Related Parties' Sharing of Business Functions and Risks
- Identification, Use and Valuation of Intangible Property
  - N.B. broad definition of IP for tax purposes.
- Tax and Business Documentation
- Tax and Business Reporting (Financial or Otherwise)

Case Study-Overview

- French Parent with U.S. subsidiary
- Worldwide Group engaged in the manufacture and sale of packaging products for the health and beauty industries
- Matrix Management-Crossing legal Entities and country boundaries
- Intercompany Transactions:
  - Sales by U.S. of French and Chinese Mfg. products.
  - Management fee Charges by France to the U.S.
  - Sales commission charges by the U.S. to France for certain French sourced product sales
- I.R.S. Transfer pricing audit adjustments proposed.

I.R.S. Assertions

- % of management and other SG&A charges represent non-deductible stewardship expenses
- Some French level activities are duplicative of activities performed by the U.S.
- U.S. sales of French manufactured products, (from two sources) should have the same U.S. profit level not a lower margin (stated in the form of commissions) for products from one of the French sources.
- With respect to U.S. sales of Chinese manufactured products, profit split vs. Comparable Profits Method (OECD TNMM).

Case Study –Tax/Business Specifics/Matrix Management Business Model

Strong Headquarter Staff in France

- Finance (budgeting, measurement of performance,
  tax and legal matters, general finance, insurance)
- Commercial;(customer relationships given global customers)
- Marketing and Communication; (public relations, advertising, website support, trade show participation, catalogues and leaflets, market and competitive intelligence).
- IT (Enterprise Resource Planning system provision, installation, support and maintenance, applications and software provision, network services, training, security).
- Senior Management (Commercial Strategy, on-going advice with regard to customer relationships).

Case Study –Tax/Business Specifics/Matrix Management Business Model

Minimal Host Country (U.S.) Staffing

- 14 Headcount
- U.S. focused to sell product and generate sales turnover.
- U.S. senior management was to maintain relationships with the company's principal customers and to sell product.
- U.S. staffing
  - One accounting manager
  - Several engineers whose principal function was to support customer sales & to liaised with product sourcing factories on behalf of customers.

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Benchmarking to Industry & Inter-Co. Transactions/Based on Sharing of Business Functions and Risks-Tangible Property

Based on internal management analysis-confirmed by independent transfer pricing analysis.

- Tangible property based on cost plus to manufacturing entity.
  - 8% for standard products; 14% covers R&D investment and Chinese mfg. costs on more premium products; 17% covers customer specific R&D
  - Independently confirmed by gross margin analysis on distribution; operating margin on combined sales/distribution
- Sales commisson-7%/10%
  - Independently confirmed by third party comparable data focusing on lack of inventory risk (title not taken by U.S.)
- IP identification, & use to Mfg. locations; value reflected in higher cost plus charges

Benchmarking to Industry & Inter-Co. Transactions/Based on Sharing of Business Functions and Risks-Services

PLR 8806002, identifies categories of intercompany services based on a determination of the beneficiary of the services. .

- Class I benefit to recipient.   These are services providing a benefit to the recipient of the services.   The service provider could derive some indirect benefit but it would be clear that these services were for the direct benefit of one or more of the subsidiary corporations.
- Class II benefit to provider.   These are services that would be non-deductible stewardship services.
- Class III benefit to group as a whole.   The third class consists of the expenses that were for the benefit of the operating members of the group as a whole.
- Class IV benefits provider but are not stewardship.   The final class consisted of expenses that were expenses of the parent company, other than stewardship expenses.

Application of PLR 8806002 Principles

- Class I benefit to recipient
  - Commercial; Marketing and Communication for U.S. operations; Finance
- Class II benefit to the provider
  - The cost of duplicative review or performance of activities already undertaken by the subsidiary;
  - The cost of periodic visitations and general review of the subsidiary's performance;
  - The cost of meeting reporting requirements or other legal requirements of the parent-shareholder that the subsidiary would not incur but for being part of the affiliated group; and
  - The cost of financing or refinancing the parent's ownership participation in the subsidiary.
- Class III benefit to the group
  - Non-specific U.S. marketing and communication;
  - Finance expenses related to overall group business review
- Class IV non stewardship provider
  - IT expenses duplicative of any incurred in the U.S.

Documentation and Reporting

- Supported deduction for management fees charged to the U.S. by providing proper classification to Class I service categories by each.
  - Keying into requirement for service recipients need for services
- Robust internal invoicing system was accessed to present support for services performed meeting tax requirements for deduction.
  - Keying into requirement for documentation of services performed by service provider
- Aligned fees charged and documentation thereof with public reporting of matrix business organization by French parent
  - Keying into requirement that service recipient would have to obtain the services elsewhere if not from related party.

Case Study-Conclusions and Comments

- Matrix vs. profit center business model
  - Answers could have been different with different business mode
  - Know differences between management and legal reporting
- Use/reference internal documentation and procedures
  - Aligns tax transfer pricing with business situation
  - Minimizes layering of "tax only" analysis on top of facts
  - Allows for management understanding of transfer pricing issues since they are presented in a familiar business context
- Robust benchmarking-transactional and industry
  - Established transfer pricing "best method", profit level indicator and range of intercompany charges

More Case Study Comments & Conclusions

- Avoid “tax advisor faux pas”
  - Not understanding the client’s business model-”tax only” layering
  - Power Point presentation to I.R.S. dismissed as unprofessional
- Manage the Economic Analysis of the business model
  - Business model profiles familiar to tax authorities
    - Value-add distributor
    - Strip distributor
    - IP developer/licensor
    - Commission agent
    - Resale agent
    - Commissionaire
    - “Center of excellence”
    - Cost plus manufacturer
    - Contract manufacturer
- TP Team-Lawyers, economists, business management

Transfer Pricing, GAAR, & BEPS

Key Chronology

- OECD BEPS report-February 13, 2013 recommended BEPS action plan.
- BEPS action plan released –July 19, 2013.
  - Actions 8,9,10,13 relate to transfer pricing.
- OECD revised IP TP draft-July 30, 2013.
- OECD White Paper on TP documentation-July 30, 2013.
- OECD memorandum on TP documentation-October 3, 2013
- Public consultation on TP rules-Paris, November 12-13, 2013.
- GAAR-EU and OECD recommendations to member states to adopt; specific country developments

BEPS Action Plan #’s 8,9, 10, 13

Changes to TP rules within the context of:

- “Global value chains” use of profit splits (two-sided methodologies versus the normal one-sided methodology of transaction net margin method or others);
- Base erosion payments, including management fees and head office expenses;
- “Hard-to-value” intangibles (“super royalties”);
- Risk-taker arrangements; and
- Clarifying when transactions can be “re-characterized”.
- Resisting resort to “formulary methods” ?
- <u>BUT WHAT IS MEANT BY “SPECIAL METHODS”?</u>

OECD revised IP TP draft

Updated Guidance/Comments

- Location savings, assembled workforce, group synergies are relevant to TP but are not IP
- IP definition for TP purposes; “something which is not a physical asset or a financial asset, and which is capable of being owned or controlled for use in commercial activities <u>and whose use or transfer would be compensated had it occurered in a transaction between independent parties</u> (expanded definition).
- Marketing intangibles-”customer facing”.
- Unique and valuable IP defined by incremental profit generating capability.
- Entities entitled to income from IP are those who contribute to successful return from exploiting the IP (anti IP holding cos.)

TP Documentation

Possible Required Information

- Income earned by country
- Taxes paid by country
- Other economic measures
  - Revenues by customer location
  - Tangible assets by location
  - Payroll
  - R&D and marketing expenses by location
- Keys into BEPS Action Plan # 13 regarding TP documentation template
- Raises issue of country sharing of information
- BUT WHAT ABOUT COMPANY PROPRIETARY TRADE AND BUSINESSS INFORMATION?

GAAR & TP

- GAAR is defined as a set of broad principles-based rules within a country's tax code designed to counteract the perceived avoidance of tax.
  - Tax law designed to deal with particular transactions of concern are termed as either specific anti-avoidance rules (SAARs) or targeted anti-avoidance rules (TAARs).
- OECD recommends adoption of GAAR as part of overall BEPS action plan implementation
- Specific country developments include:
  - India, Australia, Canada, U.K., Poland, China,
  - Also U.S. substance over form developments ("U.S. GAAR")
- TP CONCEPTS ARE DIRECTLY OR INDIRECLY AN INTEGRAL PART OF MANY OF THE TRANSACTIONS TARGETED BY GAAR
  - E.g. profit splitting, financing, thin capitalization, sham transactions

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