



Transfer Pricing: Is Your Company Paying Its Fair Share of Taxes?

B BUTZEL LONG

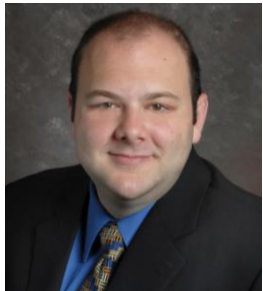
CLAYTON & MCKERVEY

Thursday, June 9, 2016



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Overview

- Why is transfer pricing a hot topic now?
- How do auditors review transfer pricing?
- What are some best practices for assessing transfer pricing issues?
- U.S., global and state developments

Is Your Company Paying Its Fair Share of Tax?



“Why does Starbucks manipulate its accounts to avoid tax?”
- UK Member of Parliament Margaret Hodge

Is Your Company Paying Its Fair Share of Tax?



“Apple wasn't satisfied with shifting its profits to a low-tax offshore tax haven. Apple successfully sought the holy grail of tax avoidance.”
- Senator Carl Levin, (D-MI)

Big Picture Transfer Pricing

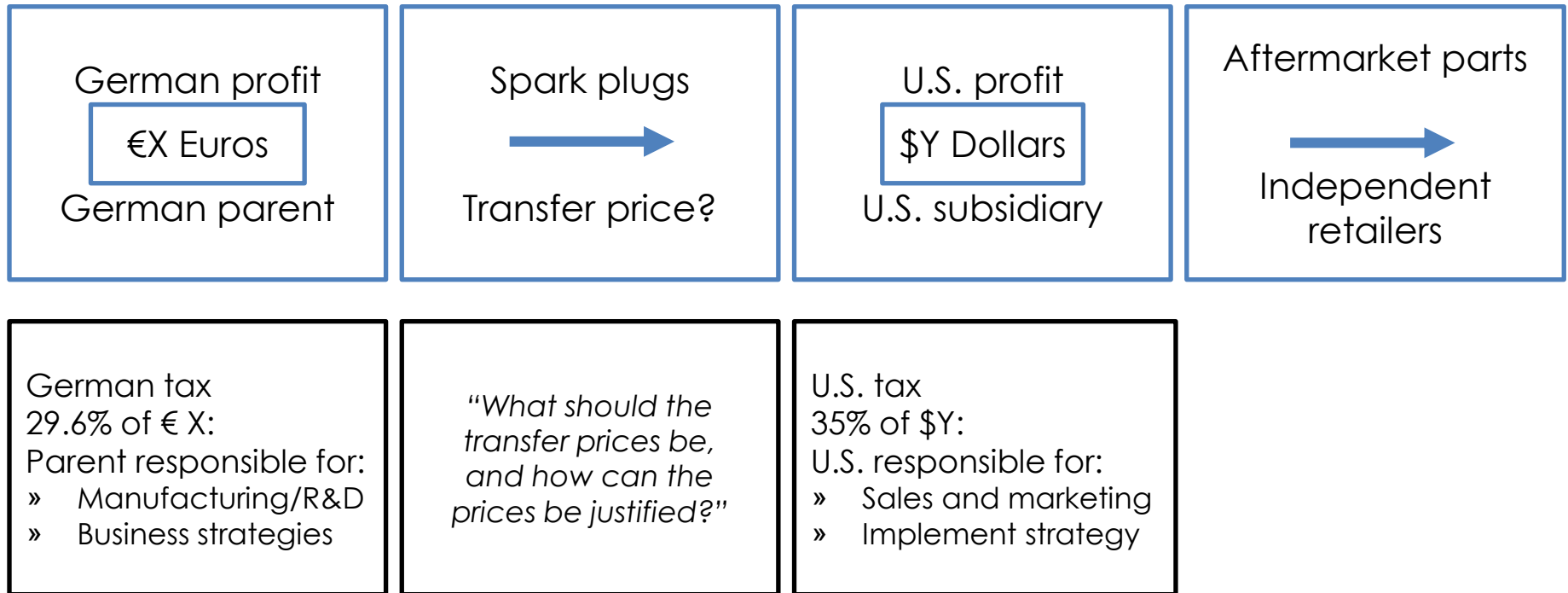
- Transfer pricing is now a corporate reputation and boardroom agenda item
- Transfer pricing disputes are regularly disclosed in SEC filings as a tax liability
- Big name companies are in the news, but now driving middle-market audits

Big Picture Transfer Pricing

Every tax authority gets their 'fair share' of income tax from multinationals

- Transfer pricing rules govern virtually all intercompany transactions, (e.g., products, royalties, services, loans)
- Intercompany pricing drives how much tax is paid by country or state

The Transfer Pricing Dilemma



Practical dilemma for multinational companies with any cross-border transactions:

- The IRS challenges if the transfer price on intercompany transactions is too high
- German tax authorities challenge if the transfer price is too low

Control - Related Parties

- Regulation 1.482-1 (i) (4)
 - Looking at reality of the control, not its form or mode of exercise
 - Control is presumed if income or deductions have been arbitrarily shifted

Arm's Length Standard

- Regulation 1.482-1(c)(1)
 - IRS transfer pricing adjustments based on whether taxpayer achieved Arm's-Length Results, not based on policies
 - Facts and circumstances crucial in assessing transfer pricing
 - Taxpayers must select the “Best Method” to show transfer prices are arm's-length
- Similar global transfer pricing rules– OECD Guidelines

Transfer Pricing – Why Now?

Globalization = many more transactions to audit

- Two tax authorities can audit every transaction

What companies have transfer pricing issues?

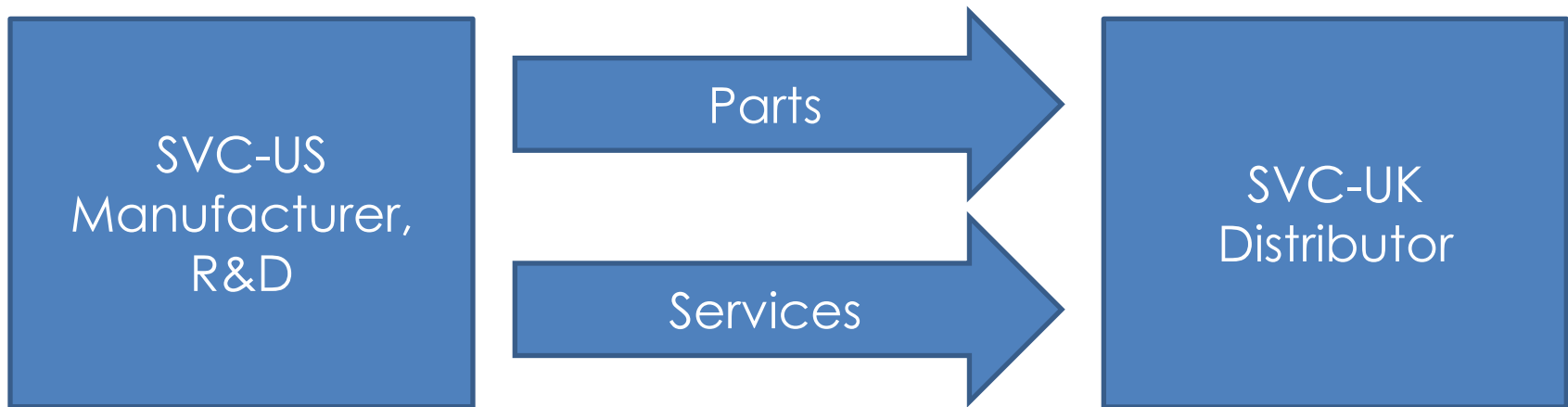
- Coca-Cola, Google, Toyota, Pfizer, Starbucks
- Any multinational with cross-border transactions
- U.S. companies with a new Canadian subsidiary

Good News. . . And Bad

Transfer pricing rules are similar globally, however:

- Not paying your fair share = large tax bills
- Popular way to raise tax revenue without raising tax rates
- Tax authorities new to transfer pricing are especially aggressive

Transfer Pricing Audits in Practice



- SVC-US earns \$2 million in profit on selling parts and providing services to a UK subsidiary
- SVC-UK earns \$11 million profit on UK sales

Transfer Pricing Audits in Practice

How Would “Arm’s-Length” Companies Operate?

IRS concludes that SVC-UK should only earn a nominal profit:

Assume a total **taxable income adjustment** of \$10 million

Additional income tax owed - \$10 million x 35% = \$3,500,000

Plus non-deductible penalties of 20%= \$700,000

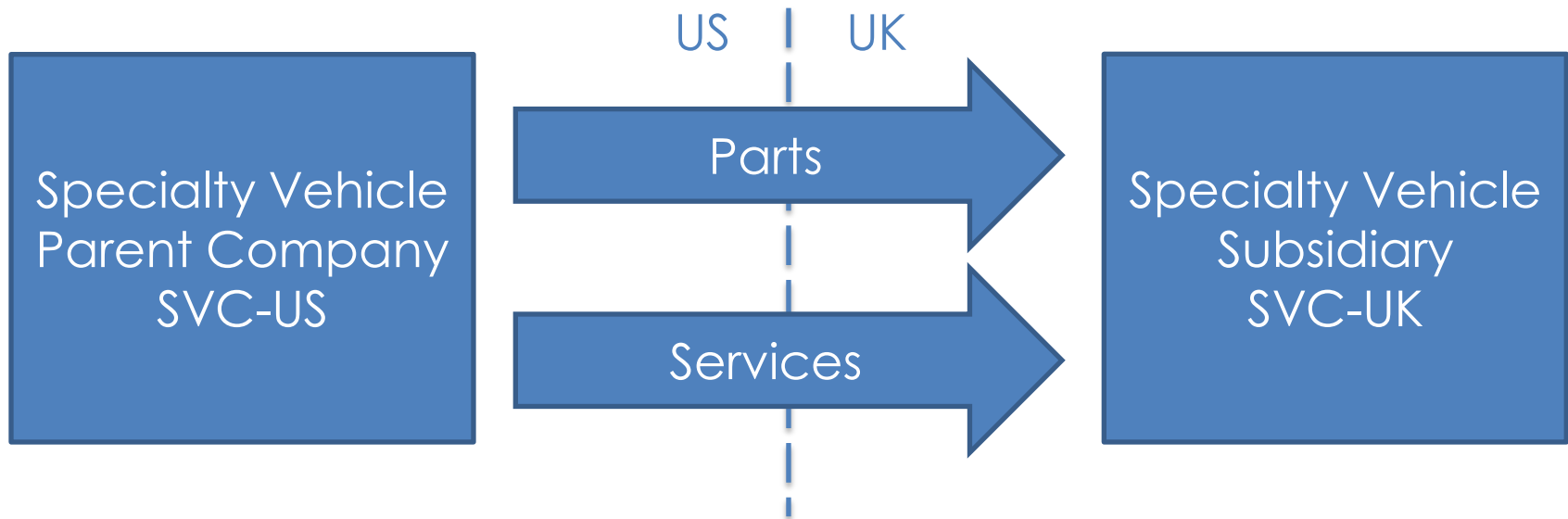
\$4.2m + interest + state taxes + potential double tax (40% penalties at \$20m)

Best Practice questions:

Would our company give up so much profit to an independent company?

Would we agree to sell someone else’s products for this level of profit?

Where Do Companies Struggle?



Where do companies struggle in transfer pricing?

- SVC is operated as one “borderless” business
- UK director’s bonus is affected by transfer pricing

How Do Companies Manage Transfer Pricing Risks?

Companies prepare **transfer pricing documentation** to manage risks:

- Explain how the business operates globally
- Explain how the industry affects the business
- Analyze transactions and financials
- Demonstrate transfer pricing is “arm’s-length” through “Best Method” economic analyses

Managing Transfer Pricing Risks

Documentation is the first line of audit defense

- Reduces penalty risks if an adjustment is applied
- Documentation requested for every IRS tax audit
- IRS now has a new 2-year audit 'roadmap' process for transfer pricing
- Some countries require documentation (e.g., Mexico, China)

Managing Transfer Pricing Risks

Rules of Thumb

- If a report does not make sense to you, it will not convince a tax auditor
- Include product pictures and website material
- Plain language explanations
- Same story for both tax authorities

Best Practices

“Best Method” is often a profitability analysis of subsidiaries

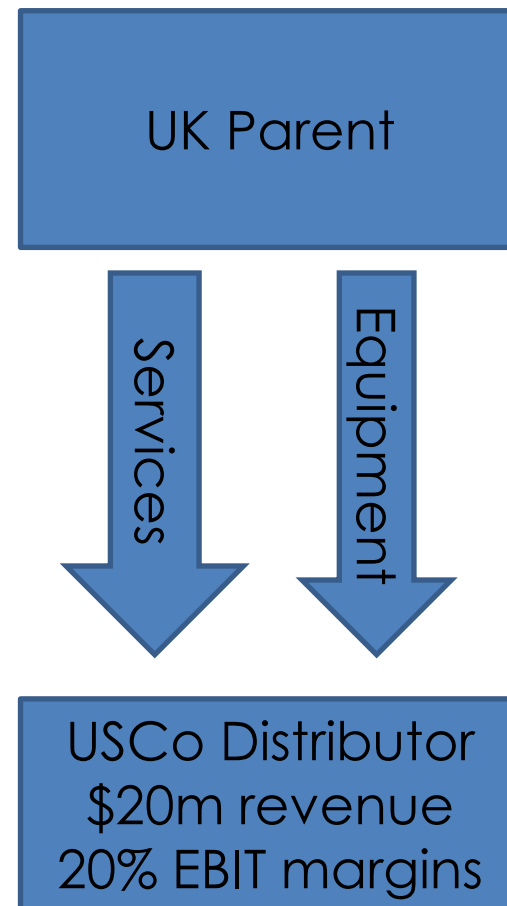
- Benchmark ‘comparables’ by reference to Earnings before Interest and Tax/Sales (EBIT/Sales)

Start with profitability of subsidiaries

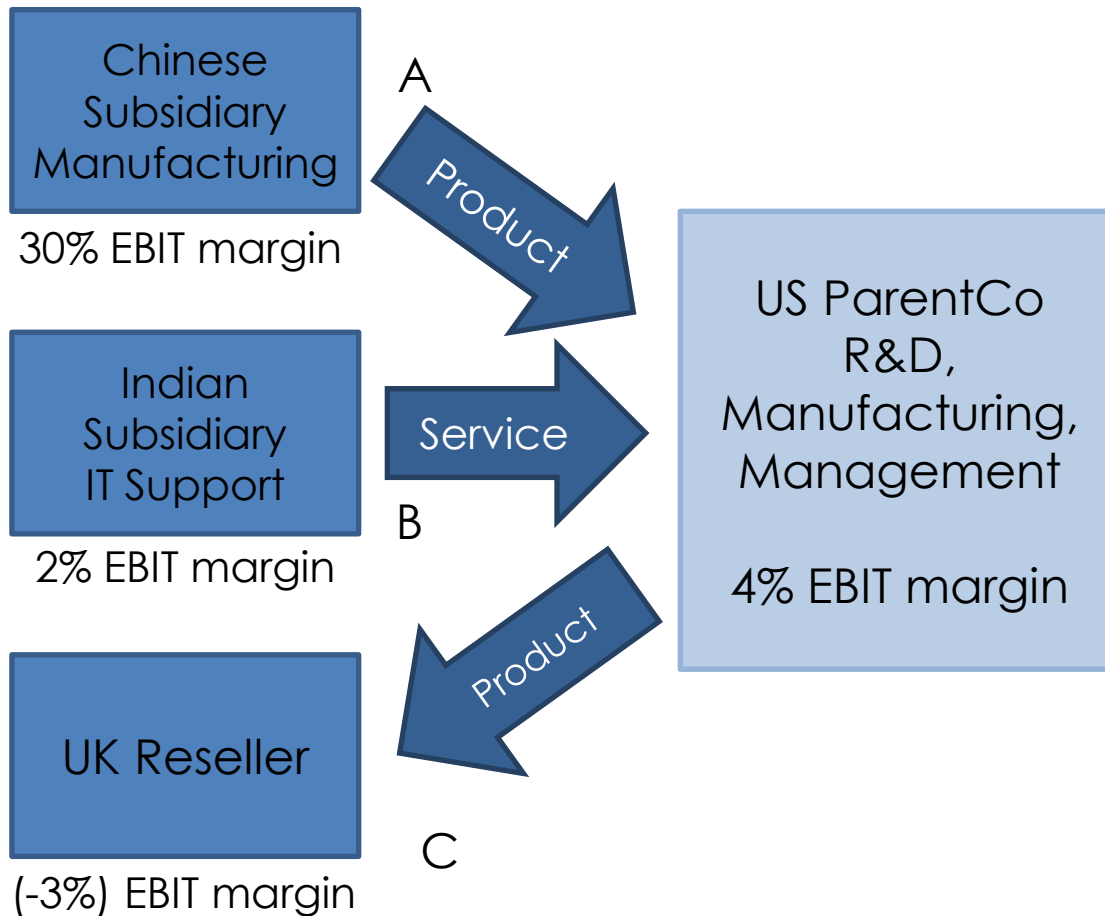
- Losses/small profits = subsidiary-side concern
- Large subsidiary profits = parent-side concern

Transfer Pricing Audit Example

- UK Parent - US Subsidiary
- IRS challenges \$3m in UK management fees
- CEO/CFO salary charged was 'excessive'
- Response – USCo is essentially too profitable



Outbound Transfer Pricing



EBIT assessment also helpful for ParentCo

- Is China an IRS risk?
- India TP risk?
- UK TP risk?
- Prioritize issues
- Transfer pricing might be correct, but often needs an explanation

Best Practices

- Operating losses are always red flags
- Large profits in subsidiaries are red flags
- Profit fluctuations are often red flags
- Does your company fit into the narrative that subsidiaries always earn profits?
- Utilizing tax net operating losses may result in unexpected benefits

LITIGATION AND RECENT TRANSFER PRICING DEVELOPMENTS

Recent Developments

Coca-Cola Tax Court Case

- Coca-Cola challenging a \$9.4B transfer pricing adjustment on licenses
- IRS previously agreed with Coca-Cola's approach - now challenging 2007-09 and recent years

Separately, Vietnam newspapers disclosed that Coca-Cola is their auditors' top target

Henry Schein Inc. v Commissioner

IRS issued a \$119 million adjustment to Henry Schien, Inc. a health-care product distributor, for 2009-2011

- IRS argues parent did not charge enough for services to subsidiaries

Auditor questions:

- Are you charging subsidiaries for services?; or
- Why is your parent company charging for services?

International Developments

The OECD has a Base Erosion and Profit Shifting (BEPS) plan – starts this year

- Focused on largest companies (above €750 million in revenue)
- All tax authorities can access to how much sales, income and tax are generated by each country
- 2016 Country-by-Country Form Filed by 12/31/17

Tax auditors essentially see how much of the tax “pie” their country is receiving versus others

International Developments

For all companies, BEPS is more prescriptive requirements to documentation

- “Master File” and “Local Files” for complying with documentation requirements
- New, higher expectations for documentation

Recent Developments

Multistate Tax Commission

- Many states have similar transfer pricing rules
- Arm's Length Adjustment Service – six states
- Increasing number of audits with outside consultants

“Our large taxpayers are shifting profits outside of the state,
and in very significant ways ...”

- Deputy Commissioner Alabama Dept. of Revenue
December 2015

Famous Last Words

Some companies have never been audited

- “Our parent company said they prepared a study”
- “We prepared a report a few years ago”
- “Our companies negotiate over transfer pricing”
- “We have a policy”
- “We have always done it this way”
- “We will prepare a report when we are audited”
- “Subsidiary losses are due to poor market conditions and foreign exchange issues”

Transfer Pricing Takeaways

- All multinational companies have transfer pricing issues
- Start by reviewing subsidiary profits – EBIT/Sales
- “Why do we earn this level of profit in this country?” is a great starting point
- Documentation, intercompany contracts and transfer pricing policies are the first lines of defense in an audit

Contact Details/Questions?



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