Transfer Pricing for Mid-Market Companies: New IRS Directives, Intercompany Agreements, Avoiding Risk and Penalties

THURSDAY, MAY 31, 2018, 1:00-2:50 pm Eastern

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I. Introduction

Our Panel

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Agenda

I. Introduction

II. Transfer Pricing Fundamentals

III. Current Developments

IV. Avoiding Risk and Penalties

V. Panel Discussion and Q&A

VI. Case Study

II. Fundamentals

Overview of Transfer Pricing

- Transfer pricing: the price paid in transactions between related (or controlled) parties
- Main types of intercompany transactions
  - Tangible goods
  - Intangible property (“Normal” versus “High-value” Intangibles)
  - Services (“Routine” versus “High-value” Services)
  - Financing (Loans, guarantees, etc.)
- Most countries require taxpayers to demonstrate that their intercompany transactions are at arm’s length
  - Primary concern: whether the taxable entities operating in the country are recognizing their “fair share” of operating profit

Controlled Transactions

- The term “related parties” encompasses commonly owned or ‘controlled’ entities and commonly ‘controlled’ transactions
- Treas. Reg. § 1.482-1(i)(4):
  - “*Controlled includes <u>any kind of control</u>, direct or <u>indirect</u>, whether legally enforceable or not, and however exercisable or exercised, including control resulting from the actions of two or more taxpayers <u>acting in concert or with a common goal or purpose</u>. It is the reality of the control that is decisive, not its form or the mode of its exercise. <u>A presumption of control arises if income or deductions have been arbitrarily shifted</u>.*”

Arm’s Length Principle / Standard

- Adopted by most OECD countries since the 1930s
- Arm’s length principle (OECD Transfer Pricing Guidelines)
  - “When the price paid between related parties is the same as the price that would have been paid between unrelated parties under the same or similar economic circumstances”
- Arm’s length standard (Treas. Reg. § 1.482-1(b)(1))
  - “A controlled transaction meets the arm's length standard if the results of the transaction are consistent with the results that would have been realized if uncontrolled taxpayers had engaged in the same transaction under the same circumstances (arm's length result)”

US Transfer Pricing Methods

- Transactional transfer pricing methods compare the price for property or services in an intercompany transaction to the price of transactions entered between independent parties under comparable circumstances
  - Comparable uncontrolled price (CUP) method (for tangible property, variations apply for services and intangible property as well)
  - Resale price method
  - Cost plus method
  - Methods similar to resale price and cost plus also apply to service transactions

US Transfer Pricing Methods (continued)

- Profit based transfer pricing methods examine overall profitability of one or more parties involved in the controlled transaction
  - Comparable profits method (CPM)
  - Profit split method
  - Income method (platform contribution transactions under cost-sharing provisions)
- Unspecified Methods

Method Selection

- No hierarchy of preferred methods in the US
- "Best method" criteria under Treas. Reg. § 1.482-1(c) is applied to select a transfer pricing method
- Consider the following in method selection:
  - comparability with the controlled transaction(s) being analyzed;
  - the reliability of the data used for the analysis;
  - the assumptions needed to apply the method; and
  - the sensitivity of the results to deficiencies in data or changes in assumption

Safe Harbors

- For certain transactions a taxpayer can follow a simple set of rules under which a national tax administration would automatically accept transfer prices
- Can be simpler than applying a transfer pricing method but may not be as optimal of an outcome
- Borrowing transactions:
  - Interest on certain loans that fall within 100% to 130% of the 'applicable federal funds rate', a government borrowing rate that fluctuates periodically
  - There is an 'interest free' period for intercompany trade accounts that arise from certain controlled transfers of tangible property or the provision of services
- Some services transactions:
  - Cost-only charge for <u>certain</u> controlled service transactions

Transactional "Other Side"

- The "other side" of the transaction will be governed by local/national regulations
- Many countries' rules are aligned with the OECD Guidelines
- The US Treasury and the IRS consider OECD Guidelines and Treasury Regulations § 1.482 to be materially the same
- To the extent there are differences, general US position is that:
  - US regulations should be followed for purposes of making or reviewing transfer pricing adjustments within the US; and
  - OECD guidelines should be followed in mutual agreement or when advanced pricing agreement ("APA") cases arise under US income tax treaties

Alignment with OECD

- A majority of OECD BEPS Action Plan action items have been part of US law, regulations or IRS practice for many years
- Examples:
  - Action Item 3: US adopted CFC anti-avoidance provisions in the early 1960s, with multiple legislative and regulatory revisions over the years
  - Action Item 4: deductible interest payments made by US subsidiaries to foreign affiliates limited by IRC Section 163(j) for many years
  - Action Item 6: US has included the limitation of benefits provisions as part of the US Model Income Tax Convention used to negotiate income tax treaties
  - Action Item 14: recent tax treaties have included mandatory arbitration provisions for unresolved mutual agreement procedure and advance pricing agreement cases
  - Country by country reports required in the US since 2016

Summary of Transfer Pricing Risks

- One-sided adjustments / double taxation
- Non-deductible penalties and interest
- Unintended transfer of intangibles
- Re-characterization of debt or equity
- Mix of losses and profits among entities in the value chain
  - High effective tax rate
  - High risks of adjustments
  - Foreign tax credit impacts

Areas of Concern by Tax Authorities

- Intercompany services
  - Are service provider entities undercharging for services?
  - Are service charge recipient entities overpaying for service

- IP migration / cost sharing / buy-in payments
  - Is IP being transferred below arm's length value?
  - Are the entities that funded up front R&D costs appropriately remunerated for the risks they undertook?
- Intercompany financing
  - Are parent companies appropriately charging out guarantee fees in situations when subsidiaries benefit from favorable credit ratings?
  - Are loans or capital contributions characterized correctly?
- Supply chain restructurings
- Permanent establishments

III. Current Developments

Developments Affecting Transfer Pricing

- Transfer Pricing Audit Roadmap (February 2014)
- Ongoing IRS Campaigns (March 2017)
  - Large Business & International Division ("LB&I") moving toward issue-based exams
  - The IRS determines which tax related issues require focus to achieve compliance objectives
  - Deploy resources to address those issues
  - Goal to focus on high risk issues, improve return selection, and make the greatest use of limited resources
- Recent IRS Transfer Pricing Directives (January 2018)
  - A Directive provides administrative guidance to LB&I examiners to promote consistency
  - Do not establish an IRS position on legal issues and are not legal guidance

IRS Related Party Transactions Campaign

- Issued March 23, 2017
- The Practice Area is Enterprise Activities
- Lead Executive: Peter Puzakulics
- This campaign focuses on transactions between commonly controlled entities that provide taxpayers a means to transfer funds from the corporation to related pass through entities or shareholders. LB&I is allocating resources to this issue to determine the level of compliance in related party transactions of taxpayers in the mid-market segment. The treatment stream for this campaign is issue-based examinations

See: https://www.irs.gov/businesses/large-business-and-international-launches-compliance-campaigns

IRS Inbound Distributor Campaign

- Issued March 23, 2017
- The Practice Area is Treaty and Transfer Pricing Operations
- Lead Executive: Sharon Porter / Ted Seltzer
- <u>US distributors of goods sourced from foreign-related parties have incurred losses or small profits on US returns, which are not commensurate with the functions performed and risks assumed</u>. In these cases the IRS may assert that the US taxpayer would be entitled to higher returns in arms-length transactions. LB&I has developed a comprehensive training strategy for this campaign that will aid revenue agents as they examine this IRC Section 482 issue. The treatment stream for this campaign will be issue-based examinations

See: https://www.irs.gov/businesses/large-business-and-international-launches-compliance-campaigns

Five Transfer Pricing Directives

Five Transfer Pricing Directives were issued January 12, 2018:

1. Interim instructions on issuance of mandatory transfer pricing information document request (IDR) in LB&I examinations ("IDR Directive")

   - IDRs will <u>not</u> be issued if Transfer Pricing Practice "TPP" and/or Cross Border Activities "CBA" Practice Area staff are not assigned to a case

   - Will be issued if TPP and CBA staff are assigned to a case, and there are initial indications of transfer pricing non-compliance risk

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Transfer Pricing Directives / Best Method

2. Instructions for LB&I on transfer pricing selection and scope of analysis - best method selection (“Best Method Directive”) (Updated Jan. 29, 2018)

   - Examiners must begin by reviewing taxpayer’s chosen method (cannot disregard it and develop a new best method analysis)
   - Approval from the Treaties and Transfer Pricing Operations (“TTPO”) Transfer Pricing Review Panel must be obtained before the IRS can change a best method
   - Requires the Advance Pricing & Mutual Agreement (APMA) Program seek formal approval to depart from the method proposed in a unilateral APA request at any time, or a bilateral APA request prior to the commencement of competent authority negotiations for the contemporaneous documentation of APAs

Transfer Pricing Directives / Penalty

3. Instructions for examiners on transfer pricing issue examination scope - Appropriate application of IRC section 6662(e) penalties (“Penalty Directive”)

   - Some penalties may apply automatically if adjustments exceed a certain threshold unless adequate contemporaneous transfer pricing documentation exists and was provided within 30 days of a request

   - The Penalty Directive reminds examiners to consider whether the study met the strictures of section 6662(d) and its regulations

Transfer Pricing Directives / Cost Sharing

4. Instructions for LB&I on Transfer Pricing Issue Selection – Reasonably Anticipated Benefits in Cost Sharing Arrangements ("LB&I CSA Directive")
   - LB&I Examiners are instructed to cease developing adjustments to CSAs "based on changing the taxpayer's multiple reasonably anticipated benefits (RAB) shares to a single RAB share when subsequent platform contribution transactions (PCTs) are added to an existing CSA until a Service-wide position is finalized"

5. Instructions for Examiners on Transfer Pricing Issue Selection – Cost-Sharing Arrangement Stock Based Compensation ("Examiner CSA Directive")
   - Instructs LB&I examiners to cease opening issues related to stock-based compensation included in CSA intangible development costs (IDCs) until the Ninth Circuit issues an opinion in the Altera case on appeal

Tax Cuts and Jobs Act (TCJA)

- Public law no. 115-97 - amended the Internal Revenue Code of 1986
- Multiple implications, including
  - Reduction in corporate tax rates from 35 percent to 21 percent
  - Broadening of tax base by limiting deductions, credits, exclusions
  - A move towards a territorial system of taxation
    - A transition rule “toll charge” on previously untaxed accumulated foreign earnings, the rate determined by whether the earnings are in cash or are on cash assets
    - Significant new anti-base erosion measures focusing on both low taxed, intangibles type earnings of CFC’s and cross border payments between US and foreign affiliates

TCJA Components

- Anti-deferral: Global intangible low-taxed income (GILTI)
- Export incentive: Foreign-derived intangible income (FDII)
- Anti-base erosion: Base erosion and anti-abuse tax (BEAT)
- Limitations on income shifting through intangible property (IP) transfers through the codification of:
  - Realistic alternative principle
  - Aggregation
  - Broader definition of intangible assets

Goal of TCJA

- Goals:
  - Change the incentive for US companies to keep profits offshore by moving to a territorial system of taxation
  - Prevent base erosion and profit shifting
- Provisions:
  - 100% exemption for dividends received by certain US parent companies from foreign subs
  - Transition tax (15.5% for cash, 8% for other)

TCJA provisions impacting transfer pricing

- Global intangible low-taxed income (GILTI)
  - Penalizes companies by subjecting foreign income derived from IP in low tax jurisdictions to current US taxation
- Foreign derived intangible income (FDII)
  - Encourages companies to develop and keep intangible property in the US rather than overseas
- Base erosion anti abuse tax (BEAT)
  - Certain companies may be taxed on certain payments made to foreign affiliates
- Limitations on income shifting through IP transfers through the codification of:
  - New definition of IP
  - Aggregation
  - Realistic alternatives

GILTI

- Similar to Subpart F in that it requires US owners of controlled foreign corporations (CFC) to include some CFC income (GILTI) as income in into the US tax base
- In essence, non-Subpart F net income of the CFC in excess of a 10% return on depreciable tangible assets is deemed to be GILTI
- A deduction of up to 50% is generally allowed (until 2026) which may reduce the effective US tax rate on GILTI to 10.5%
- Foreign tax credits are allowed - equal to 80% of the foreign tax paid
- CFCs whose income is subject to tax at an effective rate of 13.125% may be effectively ‘exempt’ from GILTI

FDII

- Incentivizes development of intangibles in the US by providing a reduced rate of US tax on a domestic corporation's portion of its intangible income derived from serving foreign markets
- Calculation is complex:
  - FDII of a US corporation is its deemed intangible income multiplied by the ratio that its foreign derived deduction eligible income bears to its deduction eligible income:
    - Deduction eligible income is gross income less exceptions and allocable deductions
    - FDII provides incentive for US companies to export property and services
    - Deemed intangible income is deduction eligible income less 10% of QBAI
    - Foreign derived deduction eligible income is derived in connection with either property sold or services rendered

BEAT

- Base erosion minimum tax designed to curtail excessive base erosion payments (namely, deductible payments to foreign affiliates)
- A US corporation is expected to pay at least a 10% tax (5% in 2018 and 12.5% beginning in 2026) on its taxable income after adding back these base erosion payments
- Payments included in the cost of goods sold or otherwise treated as reductions to gross receipts are generally not base erosion payments
- Minimum tax amount is the excess of 10% (or other applicable rate) of the taxpayer's annual "modified taxable income" over an amount equal to the taxpayer's regular tax liability, reduced by credits other than the research credit and an amount not exceeding 80% of "applicable section 38 credits"

Implications of GILTI and FDII

- GILTI makes US operations relatively more attractive and FDII provides incentives for certain export transactions
- But - location decisions are specific to facts and circumstances because GILTI, FDII and BEAT all interact
- Cost benefit of location decisions are dependent on
  - Current location of IP and, if foreign, applicable tax rate
  - Degree of alignment between IP location and the supply chain
  - Implications for future movements of IP
  - Note that increasing QBAI at foreign affiliates may decrease GILTI

Implications of BEAT

- For BEAT to apply, there must be significant related party payments to foreign affiliates
  - If BEAT applies, payments for certain services, royalties and interest to foreign related parties will be more expensive
  - Applies to both US and non US parented groups
  - Need to look at taxpayers classifications of, and payments for services
  - Consider separate invoices for separate services

Overall

- Taxpayers should evaluate their existing transfer pricing flows and structures in light of the TCJA
- Focus on US transfer pricing likely to increase:
  - From IRS: due to expanded definition of IP, as well as move to semi-territorial system
  - From foreign tax authorities: as they respond to US changes, as well as actions that US companies take to modify their supply chains
  - From clients as they look to understand implications of changes on existing structures and pricing

Codification of IP

- TCJA defines workforce in place, goodwill, and going concern as IP within the meaning of Section 936(h)(3)(B)
- Codifies the use of aggregate basis method when it achieves a more reliable result than an asset-by-asset method
- Codifies use of realistic alternatives
- “Best Method” rule still applies, so statutory changes do not require taxpayer to use any particular method. However, they do undercut criticisms of the Income Method in case law so much easier for IRS to argue for application of Income Method

IV. Avoiding Risks and Penalties

US Documentation and Filing

- Maintaining transfer pricing documentation is not affirmatively required by law or regulation
- Penalty provisions under Internal Revenue Code Sections 6662(e) and 6662(h) are triggered when taxpayers fail to reasonably comply with the documentation requirements
- Best practices to prepare for challenge by IRS and potential litigation

US Documentation and Filing

- Purpose - demonstrate that related-party pricing is arm's length
- Penalty amount correlates to taxpayer divergence from what is determined to be the arm's-length price
- Penalties may be avoided if the following requirements under Treas. Reg. § 1.6662-6(d) are met:
  - The taxpayer establishes transfer price was determined in accordance with a specified method under the Section 482 regulations and the taxpayer's use of the method is reasonable
  - Taxpayer has documentation that sets out the determination of the transfer price in accordance with such method and that its use of the method was reasonable
  - Documentation is contemporaneous to the time that the return was filed and is provided to the IRS within 30 days of its request

US and Master File CBC Reporting

- A master file report is not specifically required however the 10 principal documents required for a US transfer pricing report will meet most requirements for a master file report
- A country-by-country report that meets OECD base erosion and profit sharing standards is required for tax years beginning after June 30 2016
- The report is filed with the US income tax return on Form 8975 and the schedules included with the form
- The following 10 categories of 'principal documents' are required by the US transfer pricing regulations:

10 Principal Documents

1) Overview of the taxpayer's business, including economic and legal factors affecting pricing
2) Description of the taxpayer's organizational structure, including all related parties with relevant activities
3) Any document explicitly required by the regulations under Section 482 (e.g., a cost-sharing agreement)
4) Description of the method selected and the reason why it was selected
5) Description of the alternative methods considered and an explanation of why they were not selected
6) Description of the controlled transactions, including terms of sale and any internal data used to analyze them
7) Description of the comparables used, how comparability was evaluated, adjustments made
8) Explanation of the economic analysis and projections relied on in developing the method
9) Description of any relevant data obtained after the end of the year and before filing a tax return
10) An index of principal and background documents

Best Practices

- Two types of fact patterns meriting extra attention:
  1. Recurring losses / low profits incurred by a US entity marketing and distributing products on behalf of a foreign-related party
     - Typically the Service will apply a CPM to impute a normal operating profit (generally 2% or higher)
     - Even if there are consolidated losses on the products being sold
     - Taxpayers should be aware of the pattern
     - Understand and document how and to what extent market forces are causing results, rather than intercompany pricing

Best Practices

2. High profits are earned by a foreign affiliate of a US entity in a low-tax jurisdiction when the foreign affiliate is a licensee of intangible property licensed from the US
   - IRS may consider the CPM to treat the foreign affiliate
   - Effectively limits upside profit potential from the license transaction
   - If taxpayer used the CUT as best method be prepared to discuss and justify why it and not the CPM was chosen

- Periodic review of material intercompany transaction results is recommended
- Determine if transactions are producing arm's length results
- Consider interim adjustments to produce arm's-length results at year end

Standards and Rules Governing TP Review

- Burden of proof in a transfer pricing tax examination or in litigation rests with the taxpayer, unless the IRS alleges fraud, in which case the burden of proving fraudulent conduct lies with the IRS
- The taxpayer has a two-fold burden of proof in transfer pricing cases: it must show by clear and convincing evidence that:
  - any IRS proposed transfer pricing adjustment is "arbitrary, capricious, unreasonable amounting to an abuse of discretion"; and
  - it must show by a preponderance of evidence (greater than 50% probability) the correct arm's-length result
- When a taxpayer meets the threshold burden of proof (i.e., arbitrary or capricious), but not the second burden of proof (i.e., proving the arm's-length result), the court reviewing the transfer pricing dispute has the authority to determine the arm's-length result independently
- In practice, even if courts litigating transfer pricing cases find the IRS's proposed adjustment to be arbitrary, capricious and unreasonable, courts have generally not agreed with the taxpayer's determination of the arm's-length result

Overview of US Penalties

- Section 6662 - accuracy related penalty on underpayments - penalties that correspond to Treas. Reg. Section 482
  - Section 6662(e) – substantial valuation misstatement
  - Section 6662(h) – gross valuation misstatement

- Two different penalties
  - Transactional penalty
  - Net adjustment penalty
- To reduce the risk of a penalty:
  - Establish the arm's length nature of intercompany pricing policies
  - Create and maintain contemporaneous documentation

6662(e) and (h) Penalty Thresholds

	20% Substantial Valuation Misstatement Penalty	40% Gross Valuation Misstatement Penalty
Property Value	Value of property claimed on return is 150% or more of the determined value	Value of any property claimed on a return is 200% or more of the determined value
Reported Transfer Price (Transactional Penalty)	Reported transfer price is 200% or more (or 50% or less) of the adjusted transfer price	Reported transfer price is 400% or more (or 25% or less) of the adjusted transfer price
Net Transfer Pricing Adjustment (Net Adjustment Penalty)	Exceeds the lesser of $5 million or 10% of the taxpayer's gross receipts	Exceeds the lesser of $20 million or 20% of the taxpayer's gross receipts

Reasonable Cause and Good-Faith defense applies

Net Adjustment Penalty Example

- US manufacturer sells 50 million widgets to its European subsidiary for $5 each. → Gross sales of $250 million ($5 x 50 million = $250 million)
- IRS determines that widgets should have been priced at $5.30 each
- IRS transfer pricing adjustment is $15 million, which 6% of the manufacturer's gross receipts
  ($0.30 x 50 million = $15 million)
- Because adjustment is greater than $5 million (but less than $20 million), 20% substantial valuation misstatement penalty is applicable

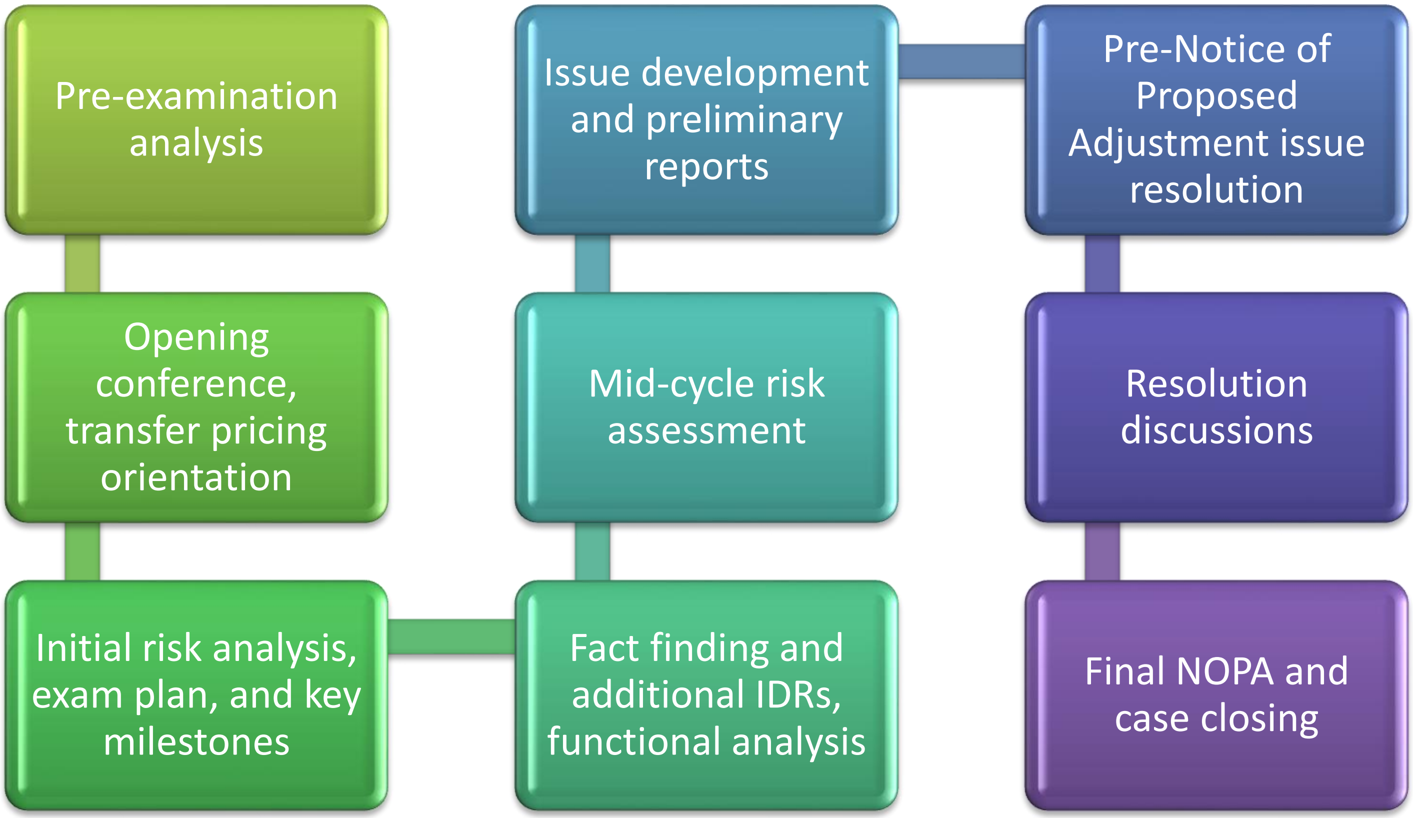
Transactional Penalty Reasonable Cause

Treas. Reg. § 1.6662-6(b)

- If only transactional penalty applies, then reasonable cause is evaluated under general reasonable cause standards of Treas. Reg. §1.6664-4
- A taxpayer may also establish reasonable cause by satisfying the reasonable cause and good faith requirements applicable to the net adjustment penalty
- If a substantial or gross valuation misstatement under the transactional penalty also constitutes (or is part of) a substantial or gross valuation misstatement under the net adjustment penalty, then the net adjustment penalty reasonable cause standards apply

Transfer Pricing Audit Roadmap (issued 2/14/2014)

24-month timeline



Provides auditors with audit techniques and tools to assist with transfer pricing examinations
https://www.irs.gov/pub/irs-utl/FinalTrfPrcRoadMap.pdf

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IRS Pre-Examination Analysis

- Review tax returns and international informational reports (e.g. Forms 5471 and 5472) for controlled transactions
- Use tax return information and available research tools to compute key financial ratio analysis for multiple years, make industry comparisons and consider whether cross border income shifting is occurring
- Research taxpayer background, history, and core business operations using publicly-available documents (e.g. SEC Form 10-K, descriptions of patents, trademarks, and other IP, etc.)
- IDR letter will request principal documents
- Statutory 30-day response time begins once initial examination letter issued (§6662(e))

Intercompany Agreements

- Not required, but the IRS has the right to impute them if they don't exist
- Can support the company establish the facts and circumstances underlying its intercompany transactions
  - Outline the functional, legal and economic risks that support a taxpayer's transfer pricing positions
- Companies should carefully adhere to these agreements and be able to produced them when requested
- Deficient agreements
  - Failure to cover key items
  - Excessively vague / poorly thought-out
  - Not well-aligned with the company's business or objectives
  - Failure to modify following structural changes

Appeals vs US Tax Court

Appeals

- Compromise resolutions possible based on strength of parties' positions; trading of issues
- Generally does not have authority to raise new issues
- Cheaper than litigation
- Confidentiality
- Informal proceeding
- Can proceed to litigation if appeal not resolved

US Tax Court

- Appeals involved in docketed cases if Appeals was bypassed
- Discovery tools available to IRS
- Public proceeding – consider exposure of confidential information
- More costly than appeals, but sometimes inevitable

Alternatives to Tax Court

- District Court
- Court of Federal Claims

Pre-Appeal and Appeal Options

- After receiving NOPA, resolve issues with auditor and team
  - Consider responding to issues that have possibility of getting resolved at exam
  - **Consider raising setoffs** for other non-arm's-length transactions between the same taxpayers for the same year
    - anticipate and develop setoffs ahead of time
    - once Form 5701 (NOPA) is issued, taxpayer has 30 days to request setoffs
  - Case managers may not consider litigation hazards in resolving cases
- Protest 30-Day Letter to Appeals
- Petition the Notice of Deficiency to US Tax Court

Appeal Options

- Request Competent Authority assistance if transactions involve a treaty country
  - If taxpayer enters into closing agreement or written settlement with the IRS, then the Competent Authority will only seek a correlative adjustment from the treaty partner and will not negotiate the amount of the adjustment
  - Consider other countries' statutes of limitations
- Negotiate with the IRS for an Advance Pricing Agreement (APA)
  - The taxpayer may enter into negotiations with the IRS for an APA at any time (even during an audit or appeal)
  - The taxpayer may request that the IRS apply the transfer pricing methodology used in the APA to the years under examination or in Appeals (a "rollback")

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Simultaneous Appeals/Competent Authority

- Taxpayers may seek simultaneous appeals and Competent Authority consideration
- May be requested at the following times:
  - When initially filing for Competent Authority assistance
    - After proposed adjustments but before protest
    - At time of filing protest
    - After appeals takes the case, but no later than 60 days after opening conference with appeals
  - Within 60 days after the case has been accepted by Competent Authority
  - When the matter is pending before a court but only with Chief Counsel's office consent
- Once Competent Authority accepts an issue, it obtains jurisdiction over that issue.

Tax Court Litigation Generally

- Discovery procedure differ from federal district court
  - *Branerton* letters
  - Formal discovery
- Protective Orders for confidential business information and trade secrets
  - IRS generally objects
- Expert witnesses, including economists
  - Original expert who performed transfer pricing study vs. new expert
  - Expert witness report
  - Excluding an expert witness
  - Trial testimony of an expert witness

V. Panel Discussion and Q&A

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Focus on the Facts

- Focus on planning and implementation
  - Keep the whole structure and its objectives in mind
  - Always document with intercompany agreements
  - Use experienced transfer pricing economists to review and price the transactions based on the functions, assets, and risks of the related parties
  - Prioritize transactional methods if you can – courts prefer them
  - Recognize global transparency requires consistent messages to all governments
  - Understand the impact of treaties or their absence
  - Model potential impacts of GILTI, FDII, BEAT to understand risks

Follow a Disciplined Process

- IRS Audit Guide
- Negotiation strategy
  - BATNA (best alternative to a negotiated agreement)
  - Understand tax authority position
- Engage in clear and concise communications
- Maintain professionalism and courteousness

Some Key Takeaways

- The IRS and tax authorities of other countries are going after small and mid-sized companies that may not be ready for this scrutiny
- Just because a Company has been audited in the past does not mean the IRS has signed off on its transfer pricing policies and results
- Audits and resulting adjustments to taxable income typically involve multiple years – that often quickly add up
- Transfer pricing has (at least) two sides and it is advisable to incorporate input from local transfer pricing specialists

Some Key Takeaways

(continued)

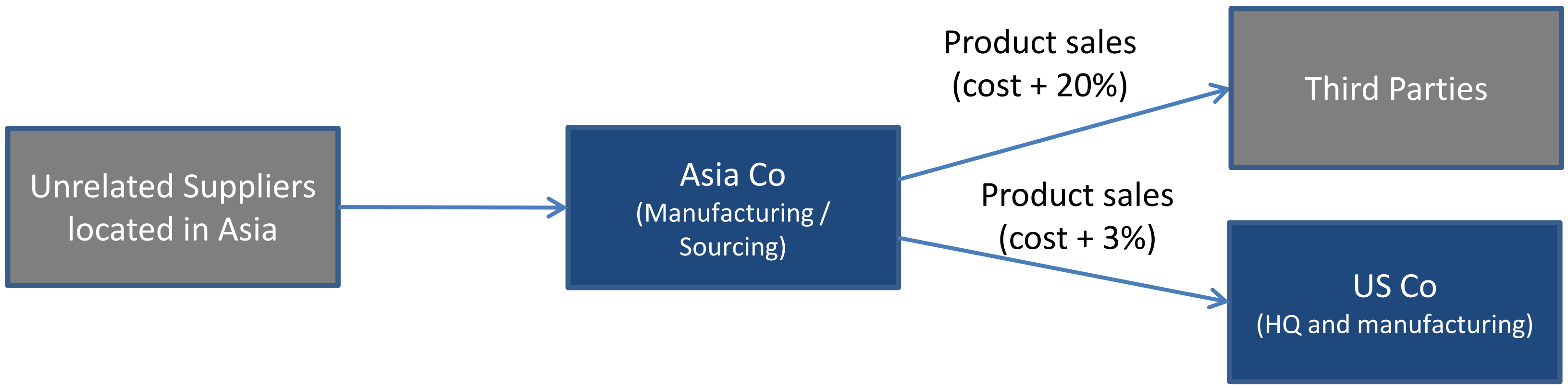
- It is better to be prepared with transfer pricing support when the tax authorities walk in than to be caught unprepared
  - Intercompany agreements
  - Transfer pricing documentation: It is less costly to develop and maintain transfer pricing documentation updated annually rather than having to react to transfer pricing adjustments (or suffer double taxation and non-deductible penalties and interest)
  - Transfer pricing audits are time consuming and expensive – and can be a slippery slope dealing with the IRS and tax authorities of other jurisdictions

VI. Case Study

Situation: Background

- The Company is a $100 million global manufacturer
- The Company's current organizational structure developed over time as the business evolved and grew (no tax planning)
- The Company was audited for its 2010 and 2011 tax years
  - The audit was closed without transfer pricing being raised as an issue
  - The Company thus erroneously assumed the IRS had signed off on the Company's existing transfer pricing policies
- The Company did not analyze its transfer pricing policies or results and did not prepare documentation for any years

Situation



- Headquartered in US ("US Co")
- Asia Co performs sourcing functions (such as identifying and managing suppliers and contract manufacturers), design functions and other support
- US Co was very involved in Asia Co's operations
  - For example, US Co was responsible for final approval for any significant business decision or activity

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IRS Transfer Pricing Audit and Proposed Adjustments

- In 2015, US Co was under a transfer pricing audit for 2012
- The IRS issued a memorandum proposing adjustments for imputed transactions:
  - Asia Co's use of product designs ("IP") developed by US Co
  - US Co's provision of market development, design, and a number of other management services to Asia Co
- The IRS asserted that US Co underreported nearly $2 million of 2012 income improperly retained by Singapore due to non-arm's length transactions
- Since US Co did not have contemporaneous transfer pricing documentation in place, the IRS memorandum noted that the taxpayer is subject to penalties
- Moreover, the team anticipated tax years 2013 and 2014 would be audited. Since the company did not have contemporaneous transfer pricing documentation in place, penalties and interest on any adjustments would apply

Summary of Proposed IRS Adjustments

New Imputed Transaction:
License of Trademarks and Technology

Note: Since the IRS imputed new transactions, it would not be possible to obtain relief from Singapore since the transactions did not exist during the period of the adjustment

		IP	Services	Total
Proposed adjustments		550,000	1,400,000	1,950,000
Additional US tax	35%	192,500	490,000	682,500
US penalty exposure	40%	77,000	196,000	273,000
Interest		25,000	60,000	85,000
Total exposure		**294,500**	**746,000**	**1,040,500**

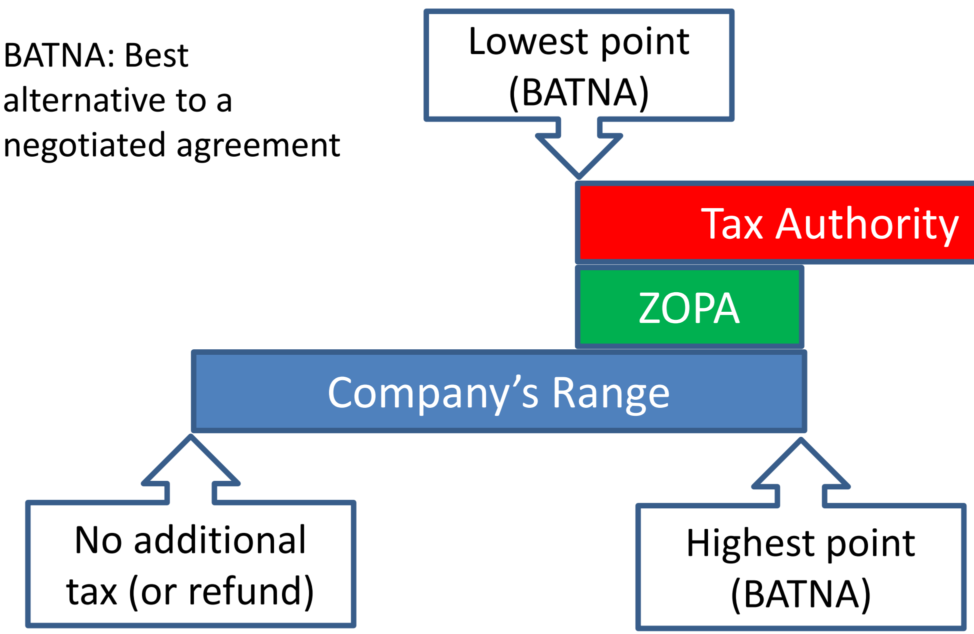
Penalties and interest are non-deductible

New Imputed Transaction:
Provision of Services

Zone of Possible Agreement (ZOPA)

- The intellectual zone where the parties can reach agreement
- Outside the zone no amount of negotiation will yield an agreement

BATNA: Best alternative to a negotiated agreement



Factors that may impact the ZOPA

- Additional costs and time
- Hazards of litigation
- Precedent
- Future compliance
- Emotional factors
- Etc.

Proposed Adjustments and Results

Transaction	IRS Proposed Adjustments	Our Proposed Adjustments	2012 Negotiated Result	2013	2014
Management Services	1,400,000	450,000			
Royalty	550,000	0			
Tangible Goods	0	-250,000			
Total adjustments	**1,950,000**	**200,000**	**250,000**	**0**	**0**

~13% of the IRS's proposed adjustment

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