

Transfer Pricing

The authors examine the Internal Revenue Service's audit campaign strategy—in particular, the related-party transactions campaign—and what it means for mid-market taxpayers. For those taxpayers, the IRS appears to believe the critical area of transfer pricing non-compliance lies not in traditional corporation-to-corporation or intangible property transactions, but intercompany transfers of funds from corporations to entities that pay no corporate income taxes.

The IRS's Related-Party Transaction Campaign: Looking Through a Transfer Pricing Lens

BY JOYCE BEEBE AND KELLY GRANADO

The IRS's Large Business and International division in January announced the identification and selection of 13 "campaigns." The overall purpose of this effort, as described by the announcement, is to focus future efforts on issue-based examination in order to achieve compliance objectives. These specific issues are identified based on a risk approach—in other words, LB&I believes they represent the highest risk of non-compliance.

With limited resources, the IRS seemingly would focus on specific issues as a first wave of campaign topics that will help the IRS select returns to audit. Much has been written about the LB&I campaigns. This article

discusses these matters through the lens of transfer pricing.

Risk-Based Issue Selection

The emphasis on a risk-based issue selection process is consistent with the Organization for Economic Cooperation and Development's approach in its Action Plan on Base Erosion and Profit Shifting (BEPS), the organization's comprehensive rewrite of the global tax guidance. Specifically, Action 13—the action calling for country-by-country reporting of large companies' global taxes and profits—is the OECD's response to tax administrations' demand for transparency about company operations and meets their risk assessment needs. Actions 8-10, the other BEPS transfer pricing action items, illustrate risk-based approaches, with a multi-step process that begins by requiring taxpayers and tax administrations to identify economically significant risks with specificity.

The related-party transactions campaign (RPTC) specifically targets "mid-market" taxpayers, a term that can (and does) mean different things to different people—including tax administrations and field auditors. Assuming that it is somehow possible for a tax administrator to "know mid-market when one sees mid-market," the RPTC is particularly significant because it results in an audit rather than something else—such as for example, a soft letter to encourage voluntary self-correction, the development of a practice unit, or per-

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haps even new IRS guidance (all of which would assist many taxpayers with voluntary compliance, much more so than an aggressive field audit by a resource-constrained IRS field campaign).

Moreover, according to LB&I's description, the RPTC would focus audit attention on transactions that allow taxpayers to shift income from corporations to related pass-through entities or shareholders. The targeted transactions are wide-ranging and may involve several code sections (for example, Sections 267, 1031, and 385). As applied to Section 482 enforcement activities, however, LB&I's risk-based issue selection arguably signals that transfer pricing enforcement is not limited to scrutinizing traditional intercompany transactions, or in commonly perceived high-risk areas involving intangible property transfers. Instead, it seems to signal that heightened, campaign-styled scrutiny will follow whenever funds are transferred in controlled transactions where the fund recipients pay little or no corporate income tax.

Risk-Based Business Priorities

When one drops below the level of the very largest multinational enterprises to lesser levels of economic and financial activity, an issue-based examination appears a bit curious. Here, many companies (corporations and pass-through entities alike) may have smaller amounts of controlled transactions, or less complex types of intercompany accounts, or relatively limited human resources or in-house technical tax capabilities. Moreover, the income of pass-through entities or sole proprietors is eventually taxed at a different level (shareholder, partner, or individual). And, for companies in challenging markets and industries, many will place profitability, operations, products, service enhancements, and increased return on investment (ROI)—and even cost cutting—as their top priorities. Overwhelmingly, this is perfectly rational from an economic, financial, and business perspective, since operations and profits drive the business and tax payments—not the other way around.

For such companies, then, it is perfectly rational to perform a robust in-house risk-based assessment of the level and complexity of the requisite internal transfer pricing policies, procedures, results, and documentation. Sometimes that assessment may indicate via a “decision tree” or similar approach that the compliance costs of robust transfer pricing documentation far exceed any perceived or actual benefits. And, under the U.S. regime—in a point often misunderstood by tax authorities and taxpayers—U.S. documentation is not required. Documentation only provides penalty protection, not adjustment proofing, and it is not part of the U.S. return.

This creates a tension, because the OECD transfer pricing guidelines—although not technically law—can and are adopted in non-U.S. jurisdictions. The OECD guidelines are tremendously influential even if they are

not technically adopted in a jurisdiction. For example, a taxpayer could prepare the requisite OECD-styled documentation for another tax jurisdiction, and because of transactional or dollar volume (or some other measure), determine a “best practice” of simply relying on that documentation to support its U.S. results, if the counterparty intercompany transaction comes under scrutiny by the campaign-driven IRS auditor.

Also for many taxpayers their facts may not have changed in any material way from year to year. For example, in a situation involving a stable or regulated industry, or a routine commodity product with stable long-term market prices. In these cases, the taxpayer may simply prepare baseline transfer pricing documentation and “carry it forward,” until a material or significant change takes place, such as a new type of transaction, expanding into a new jurisdiction with substantial operations, a restructuring, or a merger or acquisition. In these cases, a U.S. taxpayer might not prepare, or refresh, its transfer pricing study more than once every two years. This approach is specifically permitted under the circa-1992 U.S. penalty regulations.

One can easily identify many situations in which a U.S. company rationally could forego preparing fresh, new IRC section 6662(e) U.S. contemporaneous documentation each year, under a thorough, rational, risk-based assessment that their existing transfer pricing policies and procedures—or perhaps the regulatory penalty-threshold amounts—fully justify that action. Although manifesting rational business behavior, this approach still leaves the company at the mercy of an IRS auditor who, perhaps driven by newfound campaign enthusiasm, somehow might determine that the results are not supported by that auditor's understanding of the economic analysis.

All things considered the campaign approach should at least provide a significant “tilt” point in the decision tree. Take, for example, the company that initially determines a very low level of transfer-pricing risk, even in the face of the “campaign initiative.” Yet, on second glance, an additional “spend” on transfer pricing studies, or freshening them, may constitute dollars well spent, when one considers the transactional costs of defending against the campaign-driven audit. Further, audit risks aside, transfer pricing studies often make good business sense since they provide key data points in assessing key planning objectives, such as cash flow, ROI, and deployment of key human and other resources and capacities.

And then, of course, there is the need to effectively manage the enterprise's worldwide tax rate. Although a tax-driven purpose or rational alone is not sufficient, no one can seriously deny that the U.S.'s high statutory corporate tax rate absolutely mandates, as a matter of sound corporate governance, the proper management of the overall ETR. From this perspective, a “mid-market” entity is not dissimilar from much larger companies—they both need sound transfer pricing analyses. Add to this, the distinct possibility that a robust study may assist in fending off an IRS campaign,

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the transfer-pricing study—often considered an unnecessary spend for otherwise compliant “mid-market” taxpayers—takes on an entirely new and positive hue.

Common Transfer Pricing Situations And Arrangements—And Some Suggestions For Addressing and Analyzing Them

We return to the reality, however, that many companies are resource constrained, and thus need to focus their best efforts on areas likely to draw the most campaign scrutiny. Stated differently, we are not necessarily suggesting that a resource-constrained company spend significant amounts on analyzing a small quantity of low-margin, generic, routine, commoditized widgets, purchased or sold in a controlled supply chain. Similarly, it does not make good financial or economic sense to devote significant resources to determine an appropriate markup for a routine, low-margin, non-value adding service. Instead, the natural questions are: Where will the IRS focus on its campaign efforts? And where should the taxpayer focus its analytical efforts? Here, other authors have addressed, quite comprehensively, the LB&I’s inbound distribution campaign; indeed, for the perspective of the “history of transfer pricing,” inbound distribution has been a focus of heightened scrutiny, since before the times of the current 1994 U.S. transfer pricing regulations.

Therefore, rather than revisit that specific campaign issue, we discuss below three common taxpayer arrangements that fit into the IRS campaigns: management fees, C corporation deductions, and intercompany financing transactions. Within each section, the authors provide comments, suggestions, and observations on what, in practice, they typically see (or implement) in terms of pricing those transactions in compliance with the arm’s-length standard.

Management Fee Arrangements

A common scenario involves a management fee arrangement, or owner-shareholder salary. Some entities are portfolio companies of private equity firms in which the firms send experienced executives to manage the portfolio companies, overseeing daily operations and human resources decisions, with the end goal of exiting the portfolio companies by either an initial public offering or sale to another private equity firm or another company. In this case, the portfolio companies are corporations, while the private equity firms are structured as partnerships. From the time when the private equity firm acquires the portfolio company until the time of exit, firm executives can devote significant efforts to streamlining portfolio companies’ operations.

Granted, the private equity firm’s intent is to achieve its own profit maximization upon exit; however, the firm’s management services should be compensated on an arm’s-length basis. These services are typically considered value-adding and critical to the competitive advantages of the recipient. As such, they are not eligible for the safe haven of Rev. Proc. 2007-13. These services are also likely to generate median markups that exceed seven percent, so the services cost method (SCM) typically does not apply. Additionally, as the private equity firms pursue their own profit maximization, they usually do not provide comparable services to unrelated entities—only to portfolio companies. And, because the

portfolio companies obtain these executive services from private equity firms, they receive no comparable services from other unrelated entities.

When the portfolio companies obtain services from third parties, it is likely that the private equity firm helped them select and evaluate alternative providers, and participation in the decision-making process normally would require C-suite involvement. These are most likely services that the private equity firm does not provide, including legal counsel. Therefore, the comparable uncontrolled services price method typically isn’t selected as the best method. Instead, the most common method is the comparable profits method (CPM).

The private equity executives would be compensated based on fully loaded costs plus an arm’s-length markup. Arguably, this is justifiable as long as companies properly document the nature and extent of services provided by the private equity firm and describe the benefits obtained by the portfolio companies, the need for these services, the appropriate allocation key, the cost base, and the arm’s-length markup. Failure to properly document these activities could cause the services to be viewed as stewardship. It is important to document the analysis: the authors have observed taxpayers using a 5 percent or 10 percent markup as a blanket charge for all intercompany management services without detailing the cost base, or the extent or nature of the services provided. This could be viewed as non-compliant.

C Corporation Deductions

Another common and simple arrangement that fits into the campaign scenario involves intellectual property and the appropriate allocation of profits based on the segregation of functions. In this scenario, the owner-shareholder usually processes or owns valuable IP or proprietary knowledge in connection with the operation of the group. As the group expands or evolves, the owner-shareholder sets up a corporation to house the operation-related activities where ordering, logistics, sourcing, warehousing, distribution, invoicing, customer support, and other back office services take place. Arguably, the vast majority of these activities and the employees that perform them don’t generate any valuable IP and the activities can be viewed as supportive. The IP could continue to reside with the owner-shareholder or with a newly established limited liability company (LLC).

Although the corporation is subject to corporation-level taxes, because of the functions performed and risks incurred, the entity is typically set up as a “cost plus entity”—that is, it holds a low level of taxable profit but can retain this profit for future expansion of the group. Depending on the function and risk profile of this corporation, if it is truly a limited-risk entity, it would always generate a taxable profit when there are no extraordinary events. This company’s only source of income is to perform services on behalf of other pass-through entities or shareholders; it has no income from third parties. As with management fee arrangements, the most common transfer pricing method in a C Corporation scenario is CPM. In this case, markups of comparable logistic or support service providers are identified.

This arrangement might be campaign-challenged when the owner-shareholder draws a sizable salary or management fee, even if these management fees are

supported by a certain type of transfer pricing analysis. Theoretically, some service providers don't engage in high-level decision making in the areas of investment, marketing, product development, or technical IP creation. In a principal-agent scenario, the owner-shareholder is the principal who provides executive-level directions and the corporation is the agent who executes based on the decisions made by the executives. In this case, unless the owner-shareholder also works as a company employee who performs daily operational activities and has a formal, measurable job description, he or she arguably already obtains the residual profit generated from the group and shouldn't draw a separate salary from the operating company.

A related but slightly different arrangement could be that the corporation pays a royalty to the owner-shareholder for the use of the IP. A common approach to benchmarking the royalty rate is to apply the comparable uncontrolled transaction (CUT) method and search for comparable third-party agreements. These can be agreements where the owner licenses the same IP to third parties or publicly available third-party agreements where companies license similar IP to other third parties. For the latter scenario, some marketing or technical IP doesn't have readily established market value, and auditors can argue that this IP isn't comparable to that owned by the publicly traded companies. It's important to carefully analyze and document the comparability between the taxpayer's IP and that from the publicly traded companies. The IP owner and related corporation should also execute an intercompany agreement. Even if taxpayers decide to apply CUT as the best method, using a profit-based method, such as CPM, to verify the profit results of the corporation, would be a good confirming measure.

Financial Transactions

Financing transactions are among the most easily overlooked intercompany transactions for many taxpayers. Often, some companies will access capital through shareholders or owners, which allows them to bypass the onerous bank validation process and perhaps waives the requirement to prepare audited financial statements solely based on the credit agreement with the bank. But this shortcut can lead to a lack of substantiation that related-party financing meets the arm's-length standard.

In transactions between unrelated parties, the borrower's creditworthiness and probability of default

need to be established to ensure proper benchmarking of an arm's-length interest rate. This process is often unnecessary when the financing occurs between, for example, parent and subsidiary, for obvious reasons. For example, the parent can make a capital contribution to an ailing subsidiary. The common reference rates include previous bank borrowing rates (even at rates obtained before the financial crisis, or during different points of business life cycle), bank quotes, or publicly available rates for the company's peers or competitors.

The issue with those common reference points is that they aren't based on the borrowing company's credit rating. None of the reference points provide appropriate arm's-length support and could result in excessively high or low rates that deviate from the borrowing company's financial health and repayment capacity at the time of borrowing. At one end of the spectrum, the owner-shareholder demands excessive interest rates of borrowing, which generate excessive interest deductions and lower taxable income at the corporation; at the other end, the owner-shareholder demands exceptionally low interest rates that aren't consistent with the market and might be driven by the cash needs of the corporation or the owner-shareholder's tax planning strategies.

Conclusion

Only time will tell whether the new issue-based campaign approach will be meaningfully different from the current audit process or the previously employed tiered issue process. Aside from the three areas above, there are other intercompany transactions that may, in time, draw attention or scrutiny. Of course, at this point, not much information exists publicly about how the campaigns will proceed or how the audits will be conducted. In the meantime, with due regard to resource constraints, taxpayers would be well advised, as a matter of best practices, to evaluate very carefully whether their entities have transfer pricing issues that likely would draw scrutiny under the RPTC, and should perform a risk-based self-assessment of the level of appropriate documentation and analysis.

Advance preparation could prevent a costly and complex examination process, and provide many corporate-governance benefits as well.

A list of sources is available at <http://src.bna.com/pXq>.