

In Practice

Business Analysis' Increasing Importance in Transfer Pricing

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The degree of alignment between a multinational company's transfer pricing systems and its business operations is an increasingly critical factor in successfully managing transfer pricing risks. In the quest to attain their share of taxable profits, tax authorities in Belgium and around the world are asking more questions about the logic behind a multinational enterprise's transfer pricing in terms of the key value drivers and risks of the business vis-à-vis the multinational group's transfer pricing policy.

Accordingly, aligning the company's transfer pricing system with its business strengthens the multinational's ability to withstand challenges by tax authorities, while at the same time managing its effective tax rate (ETR).

Business Logic Versus a Legalistic Approach

While the global group may have evaluated and developed its transfer pricing system from a legal perspective and implemented intercompany contracts to support its transfer pricing policies, tax authorities and organizations, such as the European Union Joint Transfer Pricing Forum, focused on transfer pricing issues are more concerned with the economic substance and business purpose behind these policies. For instance, the Forum often refers to the "diligent and prudent business manager" concept in its white papers.¹ Under this concept, a multinational enterprise would take the same care in setting its transfer pricing as it does in pricing to third parties.

As a result, a back-office transfer pricing documentation exercise or a legalistic approach to transfer pricing design is becoming less likely to satisfy tax authorities looking for connections between the economic substance and business purpose behind transfer pricing structures and third-party behavior. Some tax authorities are beginning to inquire directly about the time and effort spent by the multinational and its advisors gathering and analyzing the facts on which the transfer pricing system and documentation are based. If done cheaply or superficially, the enterprise faces greater risks as tax authorities are likely to become increasingly sceptical about the appropriateness of its transfer

pricing. This scepticism will likely trigger the tax authorities to dig deeper into the company's facts and assumptions.

At the same time, the fact that multinational business models are continuously evolving due to changing competitive forces and risks makes maintaining a transfer pricing system increasingly challenging. Business changes naturally impact the global group's profit drivers and how the corporate entities contribute to value creation. As a multinational centralizes, decentralizes, downsizes, enters new markets, moves to low-cost countries and acquires or merges with other companies, the importance and locations of its functions, risks and assets are affected. As a result, the alignment of the transfer pricing system with its business model becomes strained over time unless the multinational actively takes steps to realign them.

Audit Staffs Growing

A 2003 survey by Ernst & Young shows that many tax authorities are increasing the size of their transfer pricing examining staffs and the amount of training they receive.² Moreover, many tax authorities who previously did not contain transfer pricing specialists are now forming these teams. This is certainly true of Belgium, which formed a transfer pricing team in January of 2005.³ Local tax auditors in Belgium are now able to tap into a knowledgeable resource when evaluating and challenging an enterprise's transfer pricing policies, systems and results.

Moreover, many tax authorities presume that corporations should be able to readily produce supporting documentation associated with developing and maintaining their transfer pricing systems. Tax authorities typically request documentation within 60 or even 30 days of the date of their letter requesting information. For instance, the Belgium Income Tax Code specifies that the taxpayer is required to provide requested information within a month of the date the letter was sent. Taxpayers may request a one- or two-month extension to comply with the request, but they would need to explain why they are unable to provide the requested information within the normal timeframe.

Many of the questions typically posed by the tax authorities can be directly or indirectly linked to investigating the arm's-length nature of the multinational's intercompany transactions. Some tax authorities tend to focus on evaluating arm's-length behavior, while others tend to focus on examining arm's-length results. Some typical examples of inquiry are:

¹ See the EU Joint Transfer Pricing Forum Draft Paper on Risk Assessment, JTPF/004/2004/EN, dated 3/02/2004 (13 Transfer Pricing Report 225, 07/7/04).

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² See 12 Transfer Pricing Report 619, 11/12/03.

³ See 14 Transfer Pricing Report 38, 5/11/05.

- Is it reasonable to expect that third parties would be willing to enter into the intercompany transaction under the same economic circumstances?

- How well aligned is the characterization of the entity under review with its actual functions, risks and assets?

- Is the entity under review capable of managing the intellectual property that has been assigned to it via intercompany contracts?

- Given continuing workforce reductions at the local level, is the local entity under review capable of managing the business risks associated with the losses it is incurring?

The Belgium tax authority is issuing questionnaires that begin by requesting an overview of the business and progressively narrow on specific aspects of intercompany transactions. These questionnaires typically start by inquiring about the multinational's strategy. As the questionnaire progresses, more detailed questions are asked that focus on specific aspects of intercompany transactions such as whether cost allocation keys properly reflect the benefits derived from intercompany services.

For instance, the Belgium tax authority has concluded the use of net sales as the single allocation key for all cross border services provided by the enterprise is inadequate since the benefits for some services would be better reflected by other allocation keys such as a head count for human resources services and number of users for information technology services.

Tax authorities also are accessing the increasing amount of publicly available information regarding multinational enterprises' value drivers and risks. Such data is easily searchable and attainable via the internet. Finally, increased disclosure requirements and collaboration and exchange of information among the tax authorities are further elevating the exposure of a global entity that neglects to tie the consistency of its transfer pricing systems and documentation with its business model.

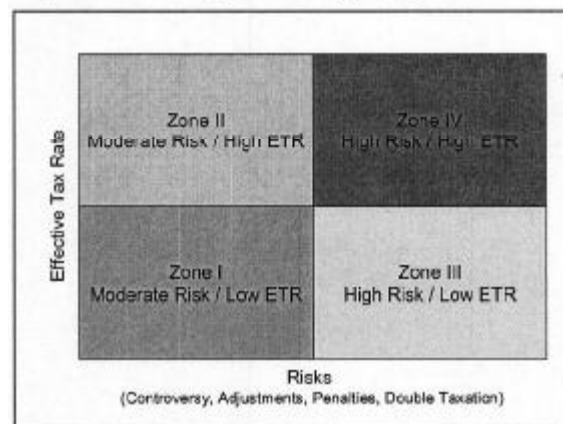
Considering the Risks Versus Rewards

In the business world, higher returns are typically driven by taking on increased risks. Transfer pricing is one area where this relationship between risks and rewards does not hold because of the nature of economic risk and legal risk. The counter-intuitive relationship between the management of transfer pricing risks and the achievement of a low ETR is illustrated in *Figure 1*.

Although these types of charts typically show the optimal situation at the upper right corner, i.e. Zone 3, this chart shows Zone I located at the lower left corner of the chart as the optimal solution. This is because through careful planning and alignment of the transfer pricing system with the business model, it is possible to achieve a sustainable low ETR while maintaining a moderate risk profile. A multinational that has strategically considered the after-tax cash flow opportunities and risks associated with the location of value drivers and business risks while considering both the legal and economic aspects of transfer pricing may achieve a transfer pricing profile in Zone I.

At the other end of the spectrum, a multinational whose business has undergone significant changes and has neglected to realign its transfer pricing system can

Figure 1: Transfer Pricing Profile



find itself in Zone IV with both a high ETR and high transfer pricing exposures. An example of this is an enterprise that has grown through acquisitions without rationalizing the transfer pricing systems of the acquired companies with the integrated business. Such an entity risks inherent contradictions in its transfer pricing policies and recognizing too much income in unfavorable tax jurisdictions.

A multinational may conclude that its transfer pricing exposures are low because it has a high ETR. This presumption may not necessarily hold. Another example of a Zone IV profile is a corporation that has downsized its local manufacturing operations to the point where country tax authorities have challenged the losses incurred in the country. For example, in the case of a manufacturing entity incurring losses, a tax authority has argued that a downsized entity is no longer capable of managing the risks associated with being an entrepreneurial entity and consequently should be recharacterized as a "contract" manufacturer rather than a "full-fledged" manufacturer.

Under such challenge, the tax authority could negate a contract manufacturing entity's current and prior year's losses. Due to the loss situation and inability to explain the relationship between the business functions and results, a multinational containing such entities could face a very high ETR and continue to be exposed to adjustments and penalties in multiple countries.

A multinational whose transfer pricing profile falls in Zones I or II has likely performed a business analysis as a cornerstone for its transfer pricing policy. This company is able to demonstrate that its entities contain ample economic substance to be able to manage the key value drivers and risks they contain.

One difference between Zones I and II may be that a multinational in Zone I is likely to have been proactive in seeking opportunities to migrate its economic value drivers and risks to favorable tax jurisdictions while the business changed. Such an entity is able to demonstrate the business case to justify changes to its system and support the economic substance of its entities located in favorable tax jurisdictions.

An enterprise striving to achieve a Zone I profile may find itself in Zones III or IV if it takes a superficial or one-sided approach to the business model in developing

its transfer pricing system. For example, Belgium has recently introduced Article 185, Section 2 which enables taxpayers to exclude the profits associated with group activities through a ruling.⁵ However, to avoid state aid issues, taxpayers would have to demonstrate that the intangibles associated with group activities are managed outside of Belgium and that the functions, risks, and assets of the Belgian entity are routine for the industry. If the multinational does not fully develop documentation that explains its transfer pricing at a global or regional level, it risks having inherent inconsistencies in its policy and may find itself struggling to answer pointed questions by the tax authorities.

Additional examples of situations that lead to Zone III and IV profiles are summarized below.

Example A: Low or No Substance Principal

A principal is formed in Switzerland to take advantage of the country's low tax rate. All residual entrepreneurial profit in the multinational's supply chain flows to Switzerland, but a substantial part of the management of the business is located in Belgium. This is a clear example of an enterprise with a Zone III profile. The Organization for Economic Cooperation and Development met with business representatives in January to discuss this type of structure. The representatives were told that tax authorities generally view principals with minimal economic substance and no compelling business purpose (*i.e.*, done with "smoke and mirrors") as abusive.

After all, two accountants and their filing cabinets in Switzerland clearly do not create the substance required to effectively operate as an entrepreneur that is responsible for managing the multinational's key value drivers and risks.

Example B: Principal

The multinational enterprise restructured its business, but centralized only the decision makers on the supply side of its supply chain in a low-taxed principal located in Ireland. The key decision makers of its distribution business remained divided among the local European countries. However, as in Example A, the multinational directed all of its residual profits to the Irish principal. Although this enterprise could legitimately claim sufficient economic substance to locate a substantial portion of its residual profits to the principal, tax authorities may challenge the characterization of the local distribution entities and claim a portion of the residual profit.

Example C: Hollow Intellectual Property Firm

A multinational contractually placed its intellectual property in Cyprus, but no employee is located on the island country is capable of managing the IP. This enterprise has a Zone IV profile as it is suffering a considerable adjustment by a tax authority due to its lack of substance in Cyprus. Additional countries may follow suit and impose assessments on this multinational.

⁵ Belgium in July 2004 amended Article 185 of the Tax Code so that profits will not be taxed if the Belgian company would not have realized them had it not been part of a related-party structure (13 *Transfer Pricing Report* 476, 9/15/04).

Example D: Central Purchasing Company

A multinational has established a central purchasing company in Cyprus. However, the distributor located in Belgium houses an employee who has a key relationship with the enterprise's second largest supplier and is negotiating and contracting on behalf of the central purchasing company. The employee's costs are charged out to the central purchasing unit with a markup. The multinational neglected to perform the careful analysis required to determine whether the activity in Belgium could constitute a permanent establishment risk enabling the tax authorities to allocate part of the central purchasing company's profitability to Belgium. Such due diligence and analysis would have helped the multinational identify the critical areas of the transactions, functions, risks, and assets so that it could have better optimized its central purchasing company to achieve a result in the Zone I quadrant.

Advantages of a Business-Centric Approach to Transfer Pricing

Each of the examples illustrate the problems that arise from designing transfer pricing systems that are not well-aligned with the business and do not take into account business realities. In all of these examples, a more substantive business analysis could have yielded a more sustainable result by either identifying a legitimate case that was more sustainable or tweaking the transfer pricing system design to better reflect business reality (*e.g.*, designing multiple principals or applying the residual profit split method). By taking a closer look at the business, it may be possible to identify higher value functionality that can lead to a stronger and more sustainable transfer pricing structure.

Global groups that are not prepared to provide tax authorities with documentation demonstrating alignment between their business models and their transfer pricing systems are increasingly incurring heavy assessments and non-deductible penalties. The authors' experience shows that multinationals without adequate transfer pricing documentation in place should be prepared to pay three to five times as much on consulting, legal fees, and additional taxes, penalties and interest than it would have had it been more proactive. This is illustrated by the cost comparative analysis shown in *Figure 2* shown on the next page.

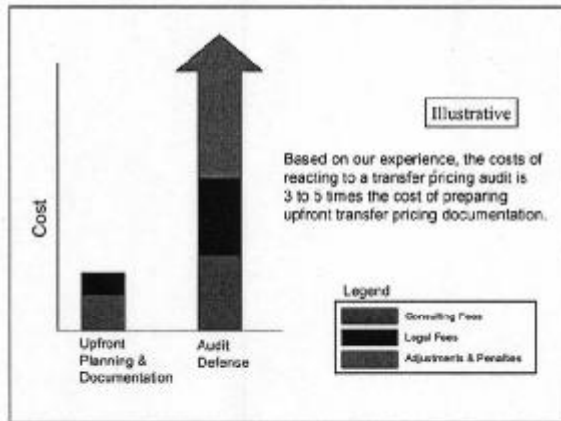
Trends

The trends illustrated in this article highlight the importance and benefits of the business analysis as a foundation in transfer pricing system design and documentation. The strength and consistency of the logic a multinational uses to explain its transfer pricing systems across various jurisdictions and transactions is a key success factor. In their efforts to encourage multi-country cooperation and consistency in approaches, the EU JTPF⁶ and the OECD are also highlighting the importance of economic substance and business purpose

⁶ The EU JTPF is a non-binding panel consisting of government representatives of member states, business representatives and OECD observers. The objective of the EU JTPF is to introduce pragmatic, non-legislative solutions within the framework of the OECD transfer pricing guidelines.

when designing and substantiating transfer pricing systems. The position among many of the participants of these organizations is that transfer pricing systems that do not reflect the economics of the business are abusive and should be challenged.

Figure 2: Cost Comparative Analysis



Given the trends described in this article, the risks associated with the costs illustrated in Figure 2 will only

increase in the future. Perhaps an enterprise is having difficulty focusing its businesses on addressing its transfer pricing needs because they are measured above the tax line or are hesitant to engage non-tax executives in transfer pricing. However, a multinational that continues to insufficiently develop its transfer pricing policies faces ever-increasing risks.

Conclusion

The importance of assessing the multinational's transfer pricing profile will increase as new policies such as Sarbanes Oxley compel corporations to more closely examine their tax exposures and tax provisions in their books. Transfer pricing is an increasingly important element in the tax provision. At the same time, transfer pricing is recognized by practitioners as one of the most difficult areas of tax to evaluate. For a corporation that has not yet developed documentation to support its transfer pricing system, the task of evaluating its exposures increases exponentially.

For most tax authorities, whether a multinational's transfer pricing is acceptable will depend on the agencies' comfort that the taxpayer is consistently following a policy that demonstrates arm's-length behavior and yields arm's-length results. An enterprise that is not prepared with well thought out transfer pricing policies and documentation may find itself on the defensive when dealing with inquisitive tax inspectors who are intensifying their focus on transfer pricing and increasingly obtaining access to business information.