Transfer Pricing:
Why The Big Deal?

By Steven D. Handler, CPA – Partner

December 2013 – Under normal circumstances, a company will determine the selling price of a product or service by evaluating a combination of factors, including the cost to produce, an allowance for overhead expenses, a fair profit, and market demand. If the price is right, buyers will buy and sellers will profit. When one party can control the price, the other party must accept that price, without regard to its economic sense.

In the case of a company selling from one country to a related party in another country, the respective local income taxes can bias intercompany pricing to push profits into one country, and avoid taxes in the other country. Most countries frown on this practice.

Transfer pricing* is the process of establishing fair prices for the transfer of goods and services among the members of a multinational group of related parties. The process applies to rents, royalties, interest on loans, and other intercompany transactions. A recent survey published in *Accounting Today* noted that tax executives' concerns about transfer pricing have increased 50% over the last year.

WHY THE BIG DEAL?

Every country's taxing authority wants to ensure that it collects its fair share of tax revenues. If a Japanese car manufacturer sells cars to a 100% U.S.-owned car distributor at retail prices, the U.S. subsidiary will either lose money or break even. All the profits would be recognized in Japan, and no income taxes would be paid in the U.S. The IRS would assert that a fair pricing arrangement had not been established. They would impose an alternate cost, using what they believe to be a fair pricing structure that will show U.S. profits. In most cases, the parent company would be prudent to establish a more equitable pricing plan that approximates what the distributor should pay if it is not a related party, i.e., a fair price at which profits will be shown in both countries. It is better to set your own idea of fair pricing than to invite the IRS to set it for you.

This is a worldwide concept. For example, the Japanese taxing authority would have the same concerns if a U.S. car manufacturer sells cars to a 100% Japanese-owned car distributor at retail prices. Multinational organizations should have written transfer pricing agreements that document the pricing arrangement between the members. These agreements should be supported by transfer pricing studies that document why the structure is fair and arm's length.

Intercompany prices should be established primarily based on the market for such goods or services. In other words, what would an unrelated party pay? The intercompany price can include discounts for volume purchases or other such efficiency factors. An affiliated company might require less support through product knowledge as compared with an outside company. A related party might have more volume than an unrelated party who deals with multiple unrelated companies. Sometimes there is no market price, such as with products that have a unique patent.

"Cost-Plus" is another acceptable transfer pricing method, in certain circumstances. "Cost-Plus" is the process of determining selling price by adding a profit factor to the seller's total cost of the goods to be sold. In a case where there is no established market price, this can be a good alternative method, but the seller and buyer must be able to demonstrate that the buyer can still make a reasonable profit at that price and there is no better alternative source for the product.

Negotiated prices are another means of establishing transfer pricing. The challenge is to demonstrate that the price was truly negotiated vs. dictated by the parent company.

The U.S. has bi-lateral tax treaties with many other countries that establish rules for the taxation of related intercompany transactions. They address apportioning multinational corporate income among the nations in which the companies conduct business, as well as taxing transactions at specified and sometimes favorable tax rates. Among other goals, these treaties attempt to preclude multinational corporate income from being double taxed.

This article provides a very brief explanation of transfer pricing concepts, agreements, and studies, in an effort to help simplify the subject. However, there is nothing simple about transfer pricing. The risks of not properly documenting transfer pricing strategies and structures are significant in both countries.

Michael Silver & Company CPAs can provide you with the expertise needed to help you enter into arm's length transfer pricing agreements with proper supporting studies and documentation. Our international transfer pricing experts can help minimize your risk in these important tax areas. If you would like to learn more about how to benefit from our knowledge, please contact me at 847.213.2107 to arrange a complimentary consultation.

Steve has been a Partner with Michael Silver & Company CPAs since 1997. His prior experience includes 15 years as a Partner in another CPA firm, and over a decade of management experience as an industry executive. Steve leads the Firm's international operations and has vast expertise with transfer pricing and other international tax matters. In addition to assisting international companies with their U.S. operations, and extensive experience in real estate, Steve is a Certified Management Consultant with expertise in mergers & acquisitions, long-range planning for closely-held businesses, compensation planning, lease negotiations and database programming.

This article addresses multinational tax-related issues of transfer pricing. Please keep in mind that there are accounting issues, as well as transfer pricing issues, among related parties within the same country that are not being addressed here.