Transfer Pricing and its Financial Reporting Consequences

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Abstract: *This article investigates the connection between transfer pricing and a company's tax and financial reporting. Transfer pricing is among the riskiest compliance and tax planning issues for multinational companies nowadays due to enhanced IRS audit processes.*

Keywords: Transfer pricing, Financial Reporting

Introduction

Many multi-national corporations have made news because of transfer-pricing issues ranging from tens of millions to hundreds of millions of dollars in possible adjustments. For example, a small, tightly owned manufacturing firm in Canton, Ohio, which wants to grow abroad may be affected by transfer pricing. This article provides a broad overview of key transfer-pricing problems, especially in terms of accounting and taxation, that practitioners need to be aware of [1].

What is transfer pricing?

In an intercompany transaction, a transfer price is the amount paid between parties that are linked (for example, a parent company and its controlled foreign subsidiary). In consolidated financial statements, intercompany transactions are eliminated as long as consolidated foreign companies and their domestic parents are consolidated (Sec. 1504(b)(3)), however for tax purposes such entities are not consolidated (they are not consolidated). Allocation of groupwide taxable income depends on transfer prices, which are included in taxes of all national tax jurisdictions. Tax laws in different countries may therefore have a direct effect on a company's after-tax revenue [3].

Taxable income for two related parties must be adjusted to better represent the income generated by each party under Sec. 482. As defined in Regulation 1.482-1(b), the actual taxable income of a controlled taxpayer is to be the income of an uncontrolled taxpayer trading at arm's length. A controlled transaction generally adheres to the arm's-length requirement if the amount of revenue received from the transaction is similar to what unrelated parties would have received under analogous circumstances.

As transfers of economic value among related parties are required to satisfy the criteria of Section 482, no transfers of economic value among unrelated parties should be permitted. Intangible products (e.g., a foreign manufacturing unit sells its production to a U.S. distributor, both controlled by a U.K. parent business) are just one example of intercompany services (e.g., intradepartmental supply or intradepartmental service). An example of a transaction susceptible to examination under Section 482 is providing intragroup services (e.g., contact centre assistance, the creation of marketing strategies, and legal and accounting services).

In order to determine the transfer pricing for a business, you have to figure out where value is generated in the organisation and is then moved among members of the group. Assets utilised, risks taken, and tasks performed are key determinants of transaction comparability when companies cross-enter into one another's operations (regs. secs. 1.482-1(c) and (d)). When it comes to paying taxes, it is the responsibility of the taxpayer to establish an acceptable economic approach stated in Regs. Sec. 1.482-3(a) for setting a range of arm's-length prices (or profits) for the transaction in issue. It is very common for tax authorities to likewise provide comparable techniques for selection. Generally, it is assumed that the transfer price used to assess taxable income across borders fits within the range calculated.

Difficultly in applying transfer pricing

In the crosshairs of tax policy, transfer pricing is the point of contention for three parties: the tax authority (i.e., government) that seeks to maximise revenue, the tax authority (i.e., government) that wants to maximise revenue, and the taxpayer (i.e., business) that seeks to minimise taxes. Even if a company makes a good-faith effort to comply with Section 482, due to inherent differences in judgement and interpretation of facts when analysing a company's transfer pricing, as well as the divergent revenue objectives of multiple tax authorities and taxpayers, there remains a significant risk of adjustments to taxable income, double taxation, and possible penalties [2].

Tax disputes may occur in a number of locations, including:

Assumptions on which the economic approach is based may be called into question by tax authorities.

The IRS may challenge the chosen economic approach

The tax authorities may believe that the taxpayer's definition of the company's value chain differs from what is really used.

Example. Another example of the dispute type that is being discussed is the 2006 settlement between the IRS and GSK Holdings (Americas) Inc. (GSK U.S.) that included transfer pricing for the years 1989 through 2005 for $3.4 billion. It was the amount that GSK U.S. paid for its production and distribution costs in the UK, as well as other costs, in conjunction with its global operating group (Glaxo Group) for cost of products sold, royalties, and other expenditures. As the medicines were created outside the United States, GSK U.S. made the argument that they had employed a global marketing strategy to promote them. So, in short, GSK U.S. was performing the normal distribution functions and was paid distribution and royalty fees that are based on the "resale price method," which is a cost-based pricing mechanism that works out the right amount by adding the distributor markup to the market price.

As a result, the IRS agreed that the demand for the medication in the United States was significantly increased due to GSK U.S.'s marketing responsibilities, and thus, GSK U.S. should be granted a considerably larger gross profit margin. In the case of GSK Group, the IRS applied the residual-profit-split method, which allocated GSK Group's U.S. and GSK Group profit in this order: routine functions performed by GSK U.S. received a share, while the remaining portion was given to the operations that had the greatest contribution to the overall GSK Group value.

Someone who strongly advocates for higher taxes

Transfer pricing is always one of the top tax worries for multinational corporations. 32% of respondents rated transfer pricing as one of the most difficult tax issues their organisation faced, according to a 2010 study by EY (Global Transfer Pricing Survey, accessible at tinyurl.com/ncu83nd). two-thirds of respondents reported undertaking a transfer-pricing audit, in contrast to the situation EY found in their 2007 study in which 52% of participants had undergone a transfer-pricing audit. One in every five audits discovered anything that led to a penalty in 2010, compared to around four percent in 2005. 66% of respondents stated controlling tax risk was their top transfer-pricing concern in the 2013 EY study (available at tinyurl.com/l47jp5n), a 32% rise between 2007 and 2010 [4].

In the future, transfer pricing positions will be riskier and less predictable. As governments increasingly have to generate money, tax authorities are asked to boost their transfer-pricing audits. The IRS has put a large amount of resources towards the use of transfer pricing models. In order to help integrate compliance activities across several worldwide regions, the LB&I division established international practise networks last year. An intellectual property (IP) issue (of which transfer pricing is among the networks' top worries) is raised in the article, "New LB&I Knowledge Management Strategies: IPGs and IPNs," in The Tax Adviser, volume 668, October 2012, page 668. While there will be fewer tax examiners focusing on smaller taxpayers with assets of less than $10 million, the IRS in the next two years will apply more resources to medium-sized taxpayers with assets between $10 million and $50 million (see "Practitioners Warn Middle-Market Companies of Heightened Transfer Pricing Scrutiny," Tax Notes Today, July 18, 2013).

The transfer pricing and financial reporting

As a company's ability to sustain transfer-pricing positions is uncertain, that may mean transfer pricing may also be considered an uncertain tax position and, in turn, impacts the amount of tax a company recognises. If transfer pricing does indeed affect a company's ability to realise deferred tax assets, this will be done in a roundabout way and have an indirect impact on the realisation of those assets.

ASC 740, Income Taxes, stipulates that only a portion of the financial statement advantage of a tax position is recognised when the tax situation passes a certain level. A two-step method is used to determine if a corporation has any uncertain tax situations.

Recognition. Only if it is more probable than not that the business will be able to maintain the tax return position will a tax advantage be shown in the financial statements.

Measurement. One should calculate a tax break as the greatest benefit that cumulatively exceeds 50% probability of really occurring.

Assume litigation will occur to the "highest court feasible" and that the IRS is aware of all pertinent information. Unrecognized tax benefits (UTBs) are liabilities until recognised. The effective tax rate for the entity as well as its tax expenditure rises. The values for all the pending uncertain tax situations are periodically reassessed and modified based on the latest available information.

Using topic 740 in transfer pricing

Understanding topic 740, which addresses transfer pricing, calls for considerable professional judgement, especially in transfer pricing roles. Regardless of the facts and circumstances, a few basic ideas may illuminate the processes that businesses use to detect UTBs.

We regard any intercompany transaction that may cause the IRS or a foreign tax authority to reassess our revenue as an uncertain tax position in the recognition phase.

Many other variables must be considered when evaluating if the position will hold up under audit, or whether the anticipated advantages would remain as a consequence of an audit. To begin, is there an advance-pricing agreement (APA) that applies to the specific transaction? APAs are negotiated agreements between the taxpayer and tax authorities about future intercompany transactions, which includes negotiations over the transfer pricing for specific transactions. Tax authorities will regard a transaction that complies with the APA to be priced at arm's length. Because of this situation, the entire tax advantage is realised.

In the absence of an APA, companies should assess their position on the strength of the documentation and economic analysis supporting the position. Also, the amount of documentation and economic analysis supporting the position must be taken into consideration. When making this assessment, one must also consider: any documentation and economic analysis demonstrating that the transaction cost parity claim is incorrect; whether the actual transfer pricing policy matches the documentation and economic analysis supporting the position; the past treatment of the tax position by both the IRS and the foreign tax authority; and how the deal looks to one party (typically a red flag that can increase the chance of a transfer-pricing audit).

Transfer pricing may influence businesses' capacity to profit from deferred tax assets since UTBs (those are expected to be taxable in the future) must be recorded. Changes to revenue caused by transfer-pricing positions are expected to result in future taxable amounts, and because of this, businesses will be able to reduce the amount of valuation allowances they claim against deferred tax assets.

Foreign subsidiaries of U.S. companies must wait until they repatriate their earnings before their tax liability is calculated. Concern Topic 740 in the event that multinational corporations have unrepatriated earnings (ie, profits that have not yet been repatriated from overseas) states that corporations do not need to recognise deferred tax liabilities on those earnings, as long as they are assumed to be “permanently or indefinitely reinvested” outside the US. Transfer pricing also impacts a multinational's tax provision via its influence on unrepatriated profits.

Compulsory disclosure requirements

In a study of financial statements produced by multinational companies, Susan Borkowski and Mary Anne Gaffney analysed the compliance implications of GAAP, particularly with regard to the issuance of equity securities (“FIN 48, Uncertainty and Transfer Pricing: (Im)Perfect Together?”). A substantial rise in both the number and quality of footnote disclosures regarding transfer pricing was seen as a consequence of Topic 740, which dealt with transfer pricing. In 2006, the average size of a transfer-pricing notice was 108.8 words. The next year, that figure increased to 140.5, 163.8, and 156.5 words. According to the authors, companies also disclosed information about the transfer pricing issues currently being disputed by tax authorities and the number of years an audit had gone on, which makes it easier for financial statement users to discern the level and nature of audit risk a multinational face.

Uncertain tax position statements that lead to transfer-pricing problems are ultimately found on Schedule UTP, Uncertain Tax Position Statement. The IRS implements the schedule UTP initiative, which became available for tax year 2010, as part of an overall effort to improve transparency and promote more compliance. For any U.S. or foreign companies that have $200,000 or more in total assets and that submit a U.S. corporate income tax return, a Schedule UTP must be filed. The asset barrier was $50 million for tax years starting in 2012 and 2013; $10 million is the new amount for all subsequent tax years (for more information, see "Schedule UTP: The Early Returns Are In," JofA, November 2012, page 54). Schedule UTP requires companies to identify each transfer-pricing position by assigning a letter (T for transfer-pricing positions) to each position, as well as a code section or sections and a detailed description of the job. Schedule UTP also requires corporations to disclose the number of their federal income tax positions in which they intend to litigate, even if they have not put a reserve on such positions because they believe they will utilise the positions in court. 21% of all transfer pricing issues were reported in the 2011 tax year, and this figure is the second-highest on the IRS's list of filings affected by UTPs, following the Sec. 41 credit for increasing research activities (the IRS website's “Transfer Pricing Filing Statistics,” available at tinyurl.com/d92o73l).

A potential impact

Transfer pricing has a significant effect on a business's financial statements even if the company is small or aggressive. Transfer pricing has the potential to have a substantial impact on your customer base, therefore you should be aware of it.

Conclusions

International transfer pricing has major consequences for tax planning and financial reporting, yet because of its implications, it is very likely to be in violation of tax laws.

Typically, defining where value is produced and transferred as well as evaluating the many variables (such as assets utilised, risks taken, and roles of the different parties) are needed in order to determine an arm's-length transfer price.

FASB ASC Topic 740, Income Taxes, describes when uncertain tax advantages arise due to transfer-pricing problems, and taxpayers are forced to evaluate the uncertain position based on the information in the document and analysis of the situation. While transfer pricing concerns that lead to an uncertain tax position are often reported on Schedule UTP, Uncertain Tax Position Statement, for eligible companies, these problems are reportable on Schedule UTP, Transfer Pricing Concerns. The complexities of financial statements have also led to increasing complexity of footnotes.

References

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