TRANSFERPRICING SOLUTIONS

Transfer Pricing – Frequently Asked Questions

What is transfer pricing?

'Transfer pricing' broadly refers to the price at which transactions between entities of multinational companies take place. The decision about what to charge for finished goods, raw materials, managerial, administrative and technical services, financial instruments and the use of intangible property will be impacted by the transfer pricing policy of a multinational enterprise (MNE).

It is important to consider the Internal pricing mechanism versus independent testing of transfer prices:

- Management/Operational Transfer Pricing: the internal pricing mechanism used by an Australian company to internally price its property or services; and
- 'Tax' Transfer Pricing: the transfer pricing method used to test the company's transfer prices and/or net profit earned on its property or services.

Transfer pricing is an important and often complicated issue faced by MNEs and this is because a transfer pricing policy can have a significant effect on business profitability, taxes paid, shareholder value and a company's overall risk management framework. MNEs are required to manage transfer pricing in a world characterised by different taxation rates, different foreign exchange rates, varying governmental regulations and in the context of increasing competition amongst revenue authorities for the lucrative tax revenue.

Why should I consider transfer pricing?

I know you probably receive a lot of information from the Big 4 about transfer pricing and often wonder if this is a real issue or just marketing.

Transfer pricing is the number one tax issue faced by many multinational companies. I am certain there is an element of marketing involved to influence you as to which service provider you use, however, as a corollary of the significant increase in global trade, especially via international inter-affiliate transactions, there has been a rise in government concerns with the loss of potential tax revenue. Tax authorities around the world are becoming more aggressive in defending their tax base. We have seen a significant increase in audit activity and resources devoted to transfer pricing review at many tax authorities, as well as more aggressive legislative enforcement efforts, including increasingly burdensome transfer pricing documentation requirements, and the imposition of onerous penalties for non-compliance with these requirements.

The USA has experienced the most significant increase in advance pricing agreement applications as many taxpayers want assurance following many high profile transfer pricing audits. Transfer pricing documentation can therefore be seen as a risk management tool. In many countries having a transfer pricing policy and also transfer pricing documentation provides relief from penalties should a dispute over pricing be challenged. Given penalties can be approximately 50% in many countries, the cost of performing transfer pricing is definitely an investment in this context.

The ATO have, since the early 2000s, recognised that international transactions will be a growing part of the Australian tax landscape. It was in 2003 when the then Commissioner of Taxation, Michael Carmody commented that:

Transfer pricing has been an area of Tax Office focus for some time and with globalisation and the significant increase in related party cross border transactions this will continue. ('Large Business and Tax Compliance a Corporate Governance Issue' Leader's Luncheon Address by Michael Carmody Commissioner of Taxation, 10 June 2003, Sydney NSW)

In August of 2012 a new bill, designed to update Australia transfer pricing legislation, passed through Parliament. Also in 2012 the ATO introduced a new tax return schedule called the international dealings schedule (replacing the schedule 25A), evidence of the ATO taking steps to record as much data as possible to assist with future compliance action. Unfortunately, for the Australian business public, this requires more disclosures by taxpayers.

What is Transfer Pricing Documentation?

Many countries around the world have transfer pricing documentation requirements. Transfer Pricing documentation requires the analysis of the company, industry and functions (including assets and risks) to be able to "characterise" the entity and transactions. Once "characterised" for transfer pricing purposes a transfer pricing method is selected and applied using an economic analysis (often called a comparable search). This comparable search is compared to the financial information of the entity being review to evaluate whether the international related party transactions have been conducted at arms-length.

What approach should we take to Transfer Pricing Documentation?

The answer to this question is highly dependent on your company's facts and circumstances. We pride ourselves in taking a practical approach that can be implemented on a day-to-day basis by your finance team. Please contact us to discuss further.

What is the Masterfile Approach?

The masterfile approach involves developing a global and segment company, industry and functional analysis, along with consistent characterisations & methods based on functionality. Local country documentation is prepared using this masterfile and adding local country company, industry and functional analysis. The initial analysis on the company and functions is performed by me with local finance teams through face to face (and telephone) meetings in each local country. The appropriate characterisation and method is selected from the group characterisations. Obviously if required, the characterisation & methods are adapted. The outcome of this is truly "local" documentation following a global platform. The masterfile;

- Creates synergies in the work processes by streamlining the work to complete the policy and documentation. These synergies should lead to reduction in workload for your employees and overall cost.
- Establish consistency and standardisation in processes and documents.
- Leverage existing analysis and document templates in countries where they have been accepted.

What are Comparables and where do we find them?

A comparable analysis means to search for "comparable companies" and benchmark a controlled transaction with an uncontrolled transaction(s) appropriate financial information (profit level indicator). A "comparable company" is not necessarily a competitor, supplier or customer. The following factors assist in determining comparability.

- Characteristics of property and services
- Functional analysis
- Contractual terms
- Economic circumstances
- Business strategies

To identify these comparable companies a search of an external database is performed based on the appropriate SIC (and other industry) codes to your company. The initial list of potential comparable companies is short listed through a series of criteria to achieve the "comparable set".

In some instances comparables can be performed on a regional basis such as Pan-European or Asia Pacific, depending on the country requirements. For example, in Asia the use of Asia Pacific comparables is common practice as local country databases are not readily available whereas in Australia there are many databases available therefore the local tax authority expects an Australian comparable search.

What is the difference between a Transfer Pricing Policy and Transfer Pricing Documentation?

The transfer pricing policy and transfer pricing documentation contain very similar information except the policy is prepared in advance focusing on what international related party transactions ("IRPT's") exist, the associated functionality and how the arms length margin should be calculated. Whereas the transfer pricing documentation is prepared after the year end and focuses on what IRPT's actually took place, the actual functionality, the amounts involved and tests this to the comparable set to ensure it is in accordance with the arms length principle.

Do we need a Transfer Pricing Policy as well as Transfer Pricing Documentation?

There is no requirement for a company to prepare both however ensuring a clear consistent approach to transfer pricing is understood by all finance teams makes the transfer pricing policy a useful tool.

Also included in the transfer pricing policy would be developing an ongoing transfer pricing review process including interim calculations to avoid year end adjustments and manage risk.

How will the documentation satisfy all local requirements?

Global documentation (non-Australian) will be prepared in accordance with the OECD guidelines. Many of the major economies around the world have local transfer pricing regulations however most follow the OECD guidelines, including the transfer pricing methods used, so this approach will be accepted. Where applicable, local country review and sign off can be arranged. This is strongly recommended for complicated, unique or high value transactions.

How can we support our intra-group financing arrangements

This is a complex and controversial area of transfer pricing. In particular, the interaction of the transfer pricing rules and thin capitalisation rules has been an area of intense contention. Transfer Pricing Solutions can help you understand any exposure you may have in relation to loans and guarantee fees.