Transfer pricing issues in recession years

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Today's agenda

- In general
  - Business issues caused by economic downturn
  - Transfer pricing: impact of downturn
- Documentation in a down economy
- Reviewing transfer pricing policies
  - Timing
  - Reactive TP tactics
  - Proactive TP tactics

In general
Business issues caused by economic downturn

- Profits turn to losses
- Longer startups
- Excess inventory
- Cash flow and debt service constraints
- Decline in capacity utilization
- Extraordinary costs
  - Reductions in force
  - Plant closures
  - Bad debts

In general
Transfer pricing: impact of downturn

- Lowered values for tangible and intangible assets
- Effect of economic crisis on goals of tax and treasury groups and how those goals relate to transfer pricing strategy
- Most transfer pricing systems assume steady conditions such as overall profitability, costs and revenues.
  - In times of recession these stability conditions are not met.

In general
Transfer pricing: impact of downturn

- **Missed profitability targets due to:**
  - **Reduced price to third parties**
  - **Reduced sales volume**
  - **Inability to reduce SG&A costs**
  - **Royalty obligations as a fixed percentage of sales**
  - **Intercompany services cost allocation**

In general
Transfer pricing: impact of downturn

- **Transfer pricing (TP) disequilibrium**
  - **Profits for routine activities, while all other affiliates suffer losses**
  - **Supply chain structures — paying a manufacturer a fixed markup or return on assets, but principal company has losses**
  - **US parent selling to foreign distributors — pricing to retain margin at distributors, but US now has significant losses <u>and</u> needs cash**
  - **Royalty structure where payor now experiencing losses**
  - **Cost plus service company charging entity that needs cash**
  - **Significant group losses but paying cash tax**
  - **TP system conflicts with where cash is needed**

Documentation in a down economy

- Key is to understand effect of economic downturn on both comparables and tested parties — good functional and industry analyses
- Some tested parties not as affected by downturn as others
- Timing of the effect of the downturn differs by industry

Documentation in a down economy Comparables selection

- **Industry comparability**
  - **Comparables from different industries are most likely to differ in terms of susceptibility to recessions**
  - **Not all companies in the same industry are similarly affected by the recession (e.g., business outsourcing companies)**
  - **When selecting comparables, consider economic measures that may be relevant for the industry under analysis**

- **Comparables data: ensure potential comparable data reflects economic reality**
  - **Update comparables to capture changed economic circumstances**
  - **Subset of previous comparables that reflects tested party sensitivity to down economy**
  - **Eliminate companies that have not been affected by the economic downturn in the same way or to the same degree**
  - **Identify companies with similar sales declines**
  - **Re-consider loss companies**
  - **Use of 10Q data (esp. for judging prices going forward)**
  - **Extend comparables' data to previous economic downturns**

Documentation in a down economy
Method selection

- Implication of actual pricing versus expectations under the CPM/TNMM
  - Market penetration
  - Subsidy payments
  - Losses at tested parties
  - Loss splits
  - Division of costs between operational and intangible created

- If difficult to find comparable companies similarly affected by the economic downturn, evaluate different TP method or PLI
  - Methods using internal data might reflect the impact of the down economy

- When adopting a new TP method consider exposure for earlier years and implication for post-recessionary years

Documentation in a down economy
Adjustment to comparables' financial data

- Comparability adjustments
  - Unforeseen economic event
  - Market adjustments
  - Plant capacity
  - Negative growth
  - Differences in asset levels (A/R, inventory levels will be up)
  - Differences in the ratio of fixed costs to total costs
  - Differences in cost structure
  - Decline in sales level
  - High operating leverage
  - FX movements
- Regressions as mechanisms to quantify impact of demand shocks and make adjustments to comparables
  - Esp. relevant for non-US data given time lag

Documentation in a down economy Statistical Measures

- Modification to range
  - Using longer time period to capture both up and down economic environment
  - Utilizing historical data for past recessionary periods
  - Use statistical methods other than interquartile to enhance reliability of the range
  - Consider using pooling or simple average vs. weighted average when not enough years' data for each comparable or significant sales decline
  - Consider different PLIs

Documentation in a down economy
Additional considerations

- An entity might rationally accept reduced profit (and potentially losses) if:
  - Expected economic profit is greater than that which can be obtained under the next most attractive option (factoring in exit costs and potential compensation payments), and
  - Expected economic profit is positive over the medium term. A temporary price reduction is then an investment in order to reap increased future profits.
- Keep records of recession impact, having contemporaneous documentation when you have lower profits or changes is key to prevailing in future audits

Reviewing transfer pricing policies

- Review of TP policies might enable multinationals to better balance and support TP results among affiliates.
- Survival in recession often necessitates a change of business strategy.
- OECD TP Guidelines implies that changes in economic conditions or business may make TP arrangements obsolete that previously were at arm’s length.
- In the presence of abnormal market circumstances, multinational enterprises should act consistently with what independent companies would do.

Reviewing transfer pricing policies
Timing

- APA Program has recognized that TP may be different in a down economy and has formed informal committee to address APA request on it
- Economic circumstances at the time the TP methodology was set-up are not comparable to the economic circumstances during a recession
- Old TP methodology might not be at arm’s length under current business strategy
- Changing TP policy with business changes
  - Existing methods are no longer best method
  - Changes in functions and risks
  - Market changes
- Changing TP policy without business change
  - Old method becomes outdated
- Company is especially hard hit by downturn (comparables likely will not show same levels of distress)
- Need for cash
- Supply chain structures “underwater”
- TP systems using fixed returns to remunerate “routine” distributors or manufacturers
- Downturn planning is an immediate cash issue as well as a documentation issue

Reviewing transfer pricing policies "Reactive" TP tactics

- It is reasonable that multinationals may require at least one financial period to react and re-organize their inter-company commercial operations. "Reactive" in that changes are made to a system already in place.
- Changes to TP methodology
  - Attach transfer prices to indexes
  - For manufacturers consider using marginal costing or capacity-based costing or incremental pricing approaches
    - The seller will recover variable costs and reduce the risk of being force to exit the market
    - The buyer can purchase products at a price that allows it to generate a minimal profit, or reduce losses
  - For services
    - Review shareholder activity cost evaluation
    - Reconsider whether to impose a mark-up
  - For licensing:
    - Assess feasibility of royalty
    - 'Stair-step' type royalty structure vs. fixed royalty
    - Royalty varies with profitability of licensee
  - Intangibles transfer
    - Lower intangible values reduce cost of transfer
    - NOLs may shelter gain on transfer

Reviewing transfer pricing policies
"Reactive" TP tactics

- Implement year-end adjustment payments
- Renegotiation of intercompany agreements
  - Set-up written TP agreements that sustain practices (i.e., clear, unambiguous and with economic logic)
- Important for certain structures – consider if short-term losses help substantiate long-term benefits
- Business restructuring to increase supply chain effectiveness or integrate acquired operations
  - Plant consolidations
  - Service center consolidations
  - Lower intangibles values reduce cost of transfer
  - NOLs may shelter gain on transfer
- Customs reconciliation program allows refund of duty

Reviewing transfer pricing policies
“Proactive” TP tactics

- Re-evaluate headquarters charges
  - Temporary services regulations — tightened definition of stewardship
  - Requirement in some circumstances to mark up costs
  - Balancing cash needs with tax risk

- Intangibles
  - Are intangibles being provided free of charge?
  - Consider items beyond “typical” intangibles, such as patents and trademarks, and examine others, such as business systems.
  - Again, balance of cash need and risk

Reviewing transfer pricing policies
"Proactive" TP tactics

- Guarantee fees
- Temporary reallocation of risk
  - Prepayments: royalties, services (retainers)
- IP migration
  - Long-term planning rather than addressing immediate cash or tax issues
  - New cost-sharing regulations
  - Low IP market value creates opportunity to transfer to low tax entity at low tax cost — additional benefit if NOLs can absorb all or part of gain

Thank you

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