Select Transfer Pricing Problems Involved in Intercompany Services

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I. Intercompany Service-Related Issues Arising From a Global Recession

A. Issues

- When a parent transfers functions and risks from a subsidiary as the result of a restructuring or consolidation, the subsidiary may be left with minimal functions, which are reimbursed or marked up at a low rate.
- Question: Do the minimal functions performed by the affiliate following the restructuring or consolidation create a permanent establishment (PE) for the principal in the affiliate jurisdiction?

- Example: Following a restructuring, an affiliate's business activities are reduced from entrepreneurial profit/loss profile to a limited risk, distributor in which many of the functions, including transportation, sales, and support activities are outsourced to third parties.

- Question: Is the affiliate post-restructuring engaged in a trade or business of its own or is it merely carrying on the business of the principal, due to the stripped down nature of its functions?

B. Tax Relief Regarding Costs Arising from Personnel Layoffs, Separations and Plant Closings

- **Where costs associated with downsizing, e.g., layoffs, separations, plant closings, etc. are incurred in the country of an affiliate entity, the question arises how those costs, which may be substantial, should be treated.**
- **Tax authorities in the affiliate jurisdiction incurring the expense may challenge deductibility of costs based on the arguments that:**
  - **(1) Decisions regarding downsizing are made by the parent company with little input from affiliate and**
  - **(2) Cost reductions benefit the global operations of the multinational group and should be shared with all countries in which the MNC does business.**

- **<u>Example</u>: Company A, the parent company of a global heavy manufacturing MNC in country X, has an affiliate B, in country Y. B manufactures products for sale in country Y and also in country X. B operates as a contract manufacturer and also a limited risk distributor for A.**
- **During an economic downturn, B's utilized capacity drops to 50%, causing a substantial reduction in the income reported from its contract manufacturing and limited risk distribution operations.**
- **Since B is a limited risk, limited function entity, should it bear the costs attributable to the reduced capacity?**

C. Cost Location Savings

- **Issue: When production is moved to a low cost location, do the savings derived from the low cost production remain there for tax purposes or do they belong to the parent company or elsewhere?**
- **There is not a consensus among taxing authorities regarding the appropriate treatment of cost location savings.**
- **Many countries, including the U.S., determine the profit to be allocated to the low cost location based on comparable transactions.**

Example:

X, a manufacturer of electronic devices, halts production in its resident country (A) and assigns all of the production to its subsidiary, Y, situated in a low cost jurisdiction. X's cost to manufacture electronic products in country A is $400. Y's cost for the same production is $200, reflecting its location savings. Y sells its products to X for $400, which realizes a mark up of 100%. No CUPs or RPM comparables are available.

The gross margin earned by local independent competitors of Y on electronic products is 40% (10% more than comparables in country A). Taxing authorities in country A adjust the transfer price to $280, reducing the gross margin earned by Y to a level that is consistent with that of the local manufacturers, 40%. Consequently, the taxing authorities for country A allocate only a relatively small portion of the actual location savings to Y.

*__Note__: **If no benefit accrues to the comparables, in terms of gross margin, then none belongs to the tested party.**

II. Specific Issues Involving Intercompany Services

1. Treatment of Equity-Based Compensation

Question: Should equity-based compensation be included in the costs related to intercompany services charged to affiliates?

- **If so, how is equity-based compensation to be valued?**
- **Comparability issues/stock based compensation costs applicable to one or more subsets of employees who are performing the specific services may not correspond to the comparables where stock-based compensation is allocated on a company wide basis.**

2. Treatment of Pass-Through Costs

Question: Which intercompany expenses should be entitled to pass through treatment on a cross-border basis without a mark up?

- **What criteria should apply in determining which expenses should be marked up/at what rate? Which expenses should be passed through without a mark up?**
- **OECD position is that uncontrolled comparables determine whether items should be marked up or treated as pass-through expenses.**
- **Question arises whether the data is sufficiently well-defined to provide guidance that would distinguish value added costs to be marked up versus expenses that should be reimbursed?**

- **Stewardship**
  - **Problems arise in countries which adopt divergent definitions of stewardship.**
  - **Question arises whether new U.S. definition of "shareholder expense" in the IRS intercompany services regulations will cause a larger charge out of expenses from U.S. headquarters that will not be accepted on audit by foreign tax authorities?**
  - **Treatment of disallowed expenses/how to obtain tax relief on charged out expenses that are rejected by certain affiliate countries.**

3. Treatment of Premium Services

Question: How should intercompany services be treated for tax purposes where intangibles are embedded in the services?

- **Should the intangibles be disaggregated?**
- **How are high valued services measured where a payment is contingent on the failure or success of the services?**
- **Example: A contingent payment arrangement for research and development where the success of the product determines the amount of the payment to the service provider.**
- **How will tax authorities react to an arrangement involving a contingent payment for high value services?**
- **Other issues involving contingent payment arrangements concern valuation of the services and/or the ability to identify uncontrolled comparables.**