RBK

Transfer Pricing

19th May 2021

JACKIE MASTERSON

HEAD OF TAX & TAX PARTNER

We're by your side

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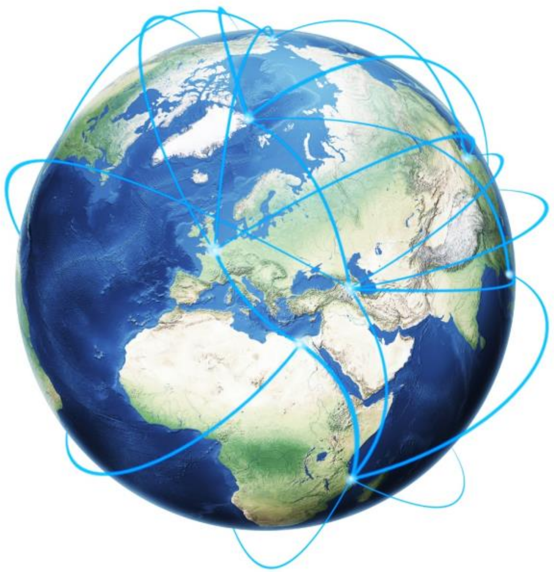
Transfer Pricing



- Legislation that governs transactions between **associated persons** and ensures taxable profits or gains cannot be understated or allowable losses overstated because the **prices charged in** or the **conditions of** such transactions are not at arms length.
- **"Arms length"** principle is an internationally agreed standard which requires that related party transactions are priced as if they were carried out by **unrelated parties dealing at arms length**, based on OECD Guidelines.
- Sets out requirements in terms of **documentary evidence** to support this pricing position.

Two Main Rules

1. If Consideration payable is more than arm's length amount, the profits / gains / losses of the acquirer recomputed using the arm's length consideration.

2. If Consideration receivable is less than arms length amount, profits / gains / losses of supplier recomputed using arms length consideration.

Why Now?

- Introduced in 2010
- Changes in Finance Act 2019 – wef 1 January 2020 onwards
- Changes in Finance Act 2020
- Revenue Updated Guidance Manual
  - TDM Part 35A-01-01
  - 24 February 2021
- Monitoring Compliance – Compliance Reviews and Audits

Back in 2010…

When originally introduced, transfer pricing legislation;

- Applied to trading transactions only – both domestic and cross border
- Did not apply to transactions where terms agreed pre 1 July 2010 ("grandfathered arrangements")
- Excluded Small and Medium enterprises (SME's) from scope
- No requirement to maintain Master or Local file documentation
- Was to be construed in accordance with the 2010 version of the OECD Transfer Pricing Guidelines

Finance Act 2019

1. Adopts 2017 OECD Guidelines which reflect the outcome of the OECD BEPs project

2. Grandfathered arrangements – now in scope for periods commencing on or after 1 January 2020

3. Provision made to bring SMEs within scope – subject to Commencement Order

4. An enterprise is regarded as an SME if the enterprise, or where the enterprise is a member of a group, the global consolidated group has;
   - A total staff headcount < 250 and either
     - Turnover < €50m or
     - Balance Sheet total < €43m

5. Arms length principle applies, subject to certain exceptions to;
   - Computation of trading income
   - Non-trading income
   - Capital allowances and
   - Chargeable gains

   between associated persons

6. Capital allowances / chargeable gains / loss – only applies where market value / expenditure > €25m

7. Non trading transactions now in scope e.g. below market rate loans/leases, subject to a domestic exemption

Non Trading Transactions – Finance Act 2019

Subject to Transfer Pricing?

Irl Co Lux Co	Interest Free Loan	✓
Irl Co Irl Co	Interest Free Loan	?
Irl Co Irl Co	Property Rent Free	?

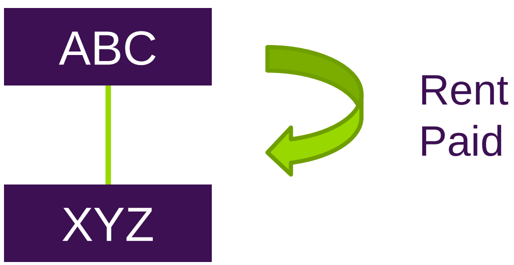
Qualifying Loans – Finance Act 2020 *

“Qualifying loan arrangements” exempt

- Applies to loans between two Irish resident companies where the lender has loaned money otherwise than in the course of a trade and the borrower is;
  - A trading company that would be entitled to claim a tax deduction for interest if charged
  - A rental company (Irish real estate) that would be entitled to deduct interest on that loan if charged
  - A holding company which uses the proceeds of the loan to on-lend other companies at interest or subscribe for or acquire shares in another company and where certain other conditions are met

* Subject to Commencement Order

Non Trading Transactions – Finance Act 2020*



Domestic Exclusion Applies where;

- If rent below market rent **BUT** greater than nominal rent
- XYZ taxed on rents and
- ABC rent deductible expense
- Transfer pricing rules / documentation do not apply to XYZ i.e. the non-trading party BUT
- Transfer pricing rules do apply to ABC BUT
- Transfer pricing rules cannot increase a trading expense (unless to compensate where income increased for other domestic party)

*** Subject to Ministerial Order**

Thresholds for Documentation Requirements

- **CT1 2020** - disclosures
- **Master File** – MNEs global consolidated turnover > €250m
- **Local File** – MNEs global consolidated turnover > €50m
- Documentation must be prepared no later than tax return deadline e.g. Dec 20 year end, prepare by 23 Sept 21
- Not filed with Revenue but must be produced within 30 days of Revenue request
- Once Ministerial Order passed, transfer pricing documentation will apply to Medium Enterprises with arrangements exceeding €1m in a chargeable period
- Small Enterprises will not be required to document transfer pricing policies
- Exclusion for previously grandfathered arrangements from documentation requirements
- Penalties – Carrot and Stick Approach

Key
Takeaways

- What is the position for SMEs? Are they still exempt?
- Extension to non trading transactions
- 2020 Compliance Obligations
- Penalties: Carrot and Stick approach

Thank you

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Transfer Pricing in Action

Common Issues (and Solutions Too!)

19 May 2021

BETTER TOGETHER

BT BENNETT THRASHER LLP

Introduction

For over four decades, Bennett Thrasher LLP has provided clients with strategic business guidance and solutions. Our Transfer Pricing practice advises businesses on transfer pricing issues and provides pragmatic solutions when deciding how to address your unique risks. Our service offerings include strategic transfer pricing planning, transfer pricing documentation and compliance, controversy management and negotiating advance pricing agreements.

WORLD TP EXPERTGUIDES TP LEADER 2021

WORLD TP RECOMMENDED FIRM 2021

BT DIVERSITY & INCLUSION

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Languages We Speak:

BT associates speak over 20 languages, including Spanish, Mandarin, Korean, German, French and Hindi, to name a few.

TP 101: Arm's Length Standard

- Where "conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly" *OECD Model Tax Treaty Article 9*

- *OECD Transfer Pricing Guidelines (2017)* provide basis for transfer pricing legislation in OECD Member Countries and in many other countries globally

- Exceptions - *United Nations Practice Manual on Transfer Pricing* for Developing Countries, country-specific policies (e.g., Brazil)

Common Issue #1
Separating Royalty Payment from Tangible Goods Pricing

Facts:

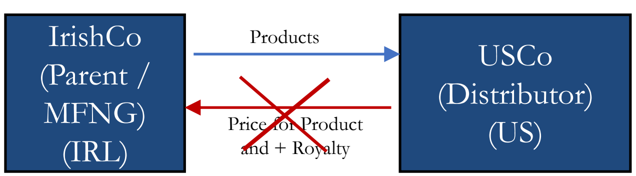
- IrishCo sells branded products to a U.S.-based affiliate to distribute in the U.S. market
- When selling to a third party, IrishCo charges a price of $350k/shipment
- IrishCo charges a royalty for brand-related IP associated with the products separately from the tangible goods price
- Transfer price is $300k ($50k for selling function):
  - ➢ $265k for product
    (product costs, plus routine return)
  - ➢ $35k royalty for IP
    (10% of third-party price)

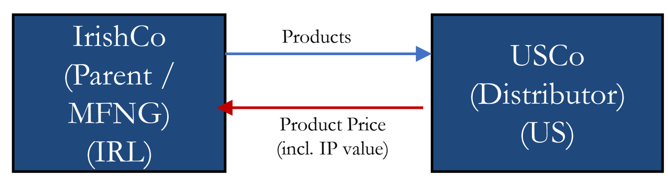
Issues:

- Disallowance of royalty transaction
- May create withholding tax on the royalty payment
- Include royalty in value used for customs declarations?
- Any separately determined royalty payment to a non-US party is not exempted from BEAT

Solution:

- Embed the value of the IP in the price of tangible product price
- I.e., transfer price for a shipment is $300k, and this is "for" the tangible property with embedded intangibles





Common Issue #2
Transfer Pricing for Subsidiaries without Personnel

Facts:

- IrishCo has been selling products to U.S. customers for several years via website and, more recently, online marketplaces and has used a 3PL to distribute in the U.S. market
- Given no physical presence, IrishCo has historically taken the position there is not a taxable presence or liability in the U.S. and filed protective returns
- Online marketplaces require IrishCo establish a U.S. entity for contracting purposes
- U.S. subsidiary entity is established, takes title to products upon arrival to 3PL and receives revenue from online marketplaces
- All personnel-related operational functions continue to be performed or managed by IrishCo personnel
- In total, IrishCo and USCo may engage in three (or even four) types of controlled transactions: tangible property, intangible property and services (financial transactions)

Issues:

- Allocation of revenue under arm's length principles is guided by the functions, risks and assets of the entities involved in a transaction, with emphasis on the significant people functions performed by each entity.
  - ➢ *Can one determine the allocation of revenue when there are **no** personnel functions in one entity?*
- Administrative burden to separately establish and mange transfer prices for 3 transactions; margin of error can lead to unreliable results
- *Sales tax issues!!

Solution:

- Aggregate transactions and price collective value as a "basket" of value transfers
- Target operating profit by reference to arm's length range of margins indicated by comparable companies
- Where necessary to manage withholding tax obligations, customs, etc. separately determine service fee or royalty

Common Issue #3: Misinterpreting Profitability Results

Facts:

- Profits-based methods evaluate transfer prices by comparing profits earned by one of the entities participating in the controlled transaction to profits of comparable companies
- Profitability measures, profit level indicators ("PLIs"):
  - ➢ EBIT Margin (EBIT / Revenue)
  - ➢ Return on Assets (EBIT / Total Assets)
  - ➢ Berry Ratio (Gross Profit / SGA)
  - ➢ Markup on Total Costs (EBIT / (COGS + SGA)
- How profits are measured impacts reliability

Issues (Solutions):

- Choosing the wrong PLI may result in transfer pricing adjustments in a tax audit
- Understanding value chains / productions functions and their key constraints is **fundamental**; e.g.,
  - ➢ Freight forwarders and general contractors (construction) have significant pass-through costs → PLIs with gross revenue or COGS likely understate profitability (Consider Berry ratio).
  - ➢ Toll manufacturers do not own significant assets (i.e., fixed assets and current assets such as inventory) → ROA will likely overcompensate manufacturer (consider NCP)

Issues (Solutions) Cont'd:

- Entity characterization is critical for assessing the arm's length character of profits reported entities that participate in controlled transactions; e.g.,
  - ➢ A German company manufactures and sells consumer goods to its IRL sister company for distribution in Europe; German company is considered least complex entity in transaction and IRL company is an entrepreneur → transfer pricing analysis of transactions evaluates German company's profits
  - ➢ Germany company's profitability is below the arm's length range; however, taxpayer concludes that pricing is arm's length because the Irish entity is in loss already (i.e., adjusting the intercompany price would put IRL in deeper loss)
  - ➢ <u>**Solution**</u>: Make adjustment so Germany earns arm's length profit margin (or perhaps one can make argument for a break-even result), which will put IRL in loss or in deeper loss; prepare transfer pricing documentation to support approach and results

Common Issue #4
Using Direct Competitors as Comparables

Facts:

- When applying a profits-based method, searches are designed to identify a set of comparable companies that indicate a return for one or more specific links(s) of the supply chain, e.g., R&D/Design, Manufacturing

- Criteria are established to identify companies with functions, risks, and assets broadly comparable to the tested party, based on the tested party's business focus (e.g., distribution); product comparability is NOT the most important criterion
- Direct competitors are usually a fully integrated business that engage in all aspects of the supply chain, as depicted above, and own valuable IP

Issue:

- Using competitors' profit margins to identify appropriate (i.e., arm's length) profit margins for entity(ies) participating in controlled transactions can lead to unreliable pricing approaches / non-arm's length results

Solution:

- Engage transfer pricing experts to review appropriateness of comparables if taxpayer wishes to do the benchmarking internally; ideally, transfer pricing experts should conduct searches for comparable companies

Common Issue #5:
Using AFR (Applicable Federal Rate) as the Interest Rate

Facts:

- Interest payments on intercompany debt are subject to scrutiny under the arm's length standard (i.e., taxpayers must charge arm's length interest on intercompany debt)
- Acceptable rates of interest under the U.S. transfer pricing regulations include (1) an arm's length interest rate or (2) the relevant AFR published by IRS for the month in which the debt is incurred The AFR is typically a lower rate of interest than an arm's length rate

Issue (Solution):

- Many taxpayers (especially SMEs) use AFR for administrative simplicity and tax certainty; however, using an arm's length interest rate may provide tax benefits
  (Solution: prepare a TP analysis to determine an arm's length range of interest rates)

	Pricing Alternatives		
	Safe Harbor (AFR)	Arm's Length Interest Rate #1 [1]	Arm's Length Interest Rate #2 [2]
Intercompany Loan from Lender to Borrower	$100,000,000		
Interest Rate	2%	7%	10%
Interest Expense	$2,000,000	$7,000,000	$10,000,000
Tax Deduction on Interest Expense (assuming 21% corporate tax rate)	$420,000	$1,470,000	$2,100,000
Tax Saving (with AFR as the benchmark)	**$0**	**$1,050,000**	**$1,680,000**

[1] Arm's length interest rate with common borrowing terms

[2] Arm's length interest rate with special borrowing terms

Common Issue #5 (cont'd): Using AFR (Applicable Federal Rate) as the Interest Rate

Issue (Solution):

- Many taxpayers (especially SMEs) use a debt:equity ratio of 1.5:1 or 2:1 to determine the portion of investment and working capital characterized as debt and equity; however, higher leverage ratios are commonly observed in the open market

  (Solution: prepare a TP analysis to determine an arm's length range of debt:equity ratios)

	"Rule of Thumb Ratio" (1.5:1)	**Arm's Length Ratio (3:1)**	**Arm's Length Ratio (4:1)**
Total Capitalization (Intercompany Capital Contribution)	$100,000,000		
Debt Level	$66,666,667	$75,000,000	$80,000,000
Interest Rate	7%		
Interest Expense	$4,666,667	$5,250,000	$5,600,000
Tax Deduction on Interest Expense (assuming 21% tax rate)	$980,000	$1,102,500	$1,176,000
Tax Saving (with rule of thumb as the benchmark)		$122,500	$196,000
Tax Saving @10% Rate (w/ RoT as the benchmark)		$175,000	$280,000

Implementing a TP Strategy

- Have a Plan and Execute It

  …in advance!

- TP Planning Study Memorializing Strategy and Underlying Rational
  - Company Overview and value-chain analysis
  - Functional Analysis
  - Entity Characterization(s)
  - Economic Analysis
- Intercompany Legal Agreements
- Evidentiary Support