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TRANSFER PRICING AFTER TAX REFORM & COVID-19

BARNES DENNIG
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Ellen T. Juram, CPA

Director

Ellen has more than 20 years of international tax experience and is an integral part of the firm's tax compliance and consulting services.

As a director, Ellen works with international clients in numerous industries, which gives her unique insights into best practices of successful companies.

She has considerable experience identifying, implementing and managing tax planning opportunities for multinational companies, including debt financing structures, acquisition planning, foreign tax credit planning and local country tax planning.

Prior to joining Barnes Dennig, Ellen spent 16 years at a Big Four firm, where she led tax engagements for multi-billion dollar, multinational companies.

ALEX MARTIN

- Full-time transfer pricing specialist for 23 years, including 4 years working overseas.
- Alex worked as an economist at a Big-4 firm for 12 years, 6 years at a top middle-market CPA firm and 4 years as an independent consultancy.
- Prior to joining KBKG, Alex's transfer pricing team was selected as one of the world's leading consultancies by *International Tax Review* for the past three years.
- Alex has also been an advisor to the World Bank, working with tax auditors in Bosnia and Herzegovina.

OVERVIEW

- Transfer pricing from a practical perspective
- Assessing transfer pricing opportunities and red flags
- Coke is it!
- Savings through utilizing tax NOLs
- Transfer pricing during a pandemic and tax reform

WHY IS TRANSFER PRICING IMPORTANT?

German Manufacturer Parent
$X profit

Auto parts →
$Y charge

U.S. distribution subsidiary
$Z profit

→ Retailers

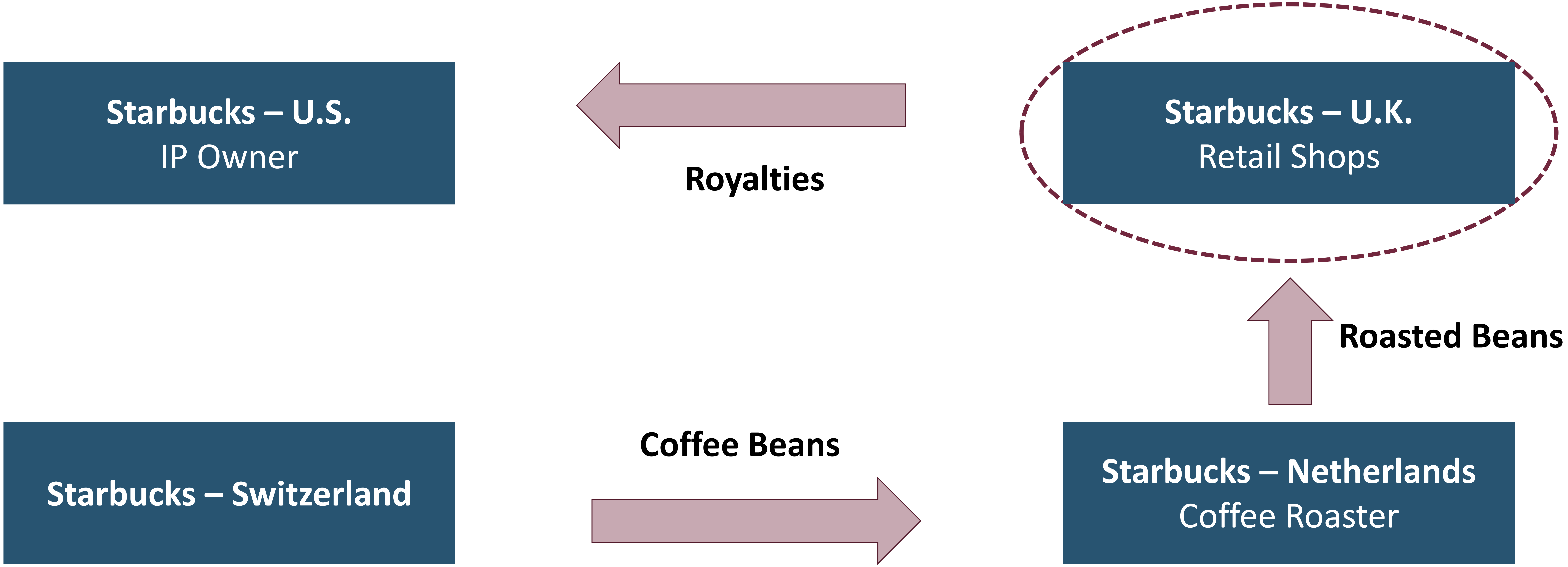
German taxes 30% of $X

U.S. taxes 35% of $Z
now 21% of $Z (2018)

$Y transfer price drives taxes payable by country

Intercompany price of goods, royalties, service charges, and loans all impact taxes paid by country

WHY IS TRANSFER PRICING IMPORTANT?



Question: where should profits be generated?

IS YOUR COMPANY PAYING ITS FAIR SHARE?

"Why does Starbucks manipulate its accounts to avoid tax?"

- UK Member of Parliament Margaret Hodge

IT'S THE REAL THING

The IRS Wins in Tax Court Against Coca-Cola 2007-2009

- Coca-Cola (US) licenses its trademarks, product names, logos, patents, formulas, and manufacturing processes
- Foreign affiliates utilize the IP to sell concentrate to bottlers
- IRS audited transactions with Brazil, Costa Rica, Egypt, Ireland, Mexico, and Swaziland

- US Tax Court released its decision on November 18, 2020
- IRS issued over $9 billion in transfer pricing adjustments
- Taxes due <u>$3.2 billion</u>

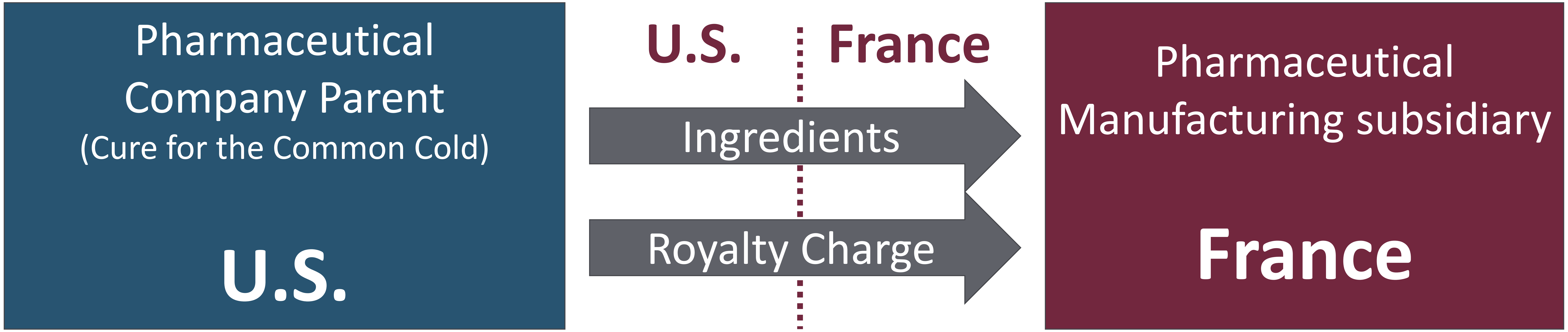
- Argument – <u>foreign subsidiaries earned excessive returns</u>

HOW ARE COMPANIES AFFECTED BY TP?

- Every US company with international operations
- Every international company with US operations
- Goods, royalties, services, loans – all transfer pricing issues
- Some companies have US state tax issues

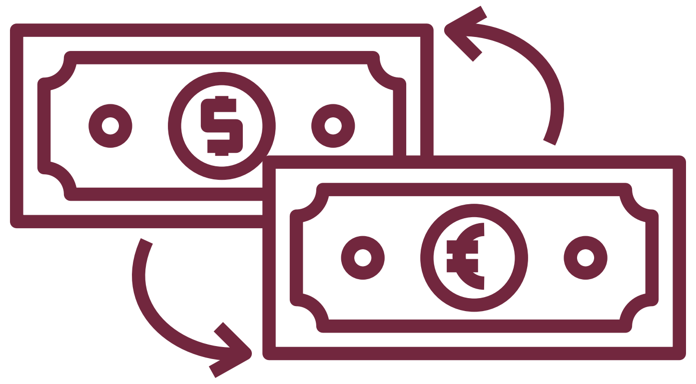
- "Arm's-Length Standard"
- Principles similar globally (OECD Guidelines)
- How can you "prove" transfer prices are correct?
- What happens if a tax auditor disagrees?

HOW DO SOME COMPANIES APPROACH TRANSFER PRICING?



- Company has one cost plus policy – (Cost + 10%)
- Company operates as one "borderless" business
- US plant manager increases transfer prices → higher US profits → bigger personal bonus

WHAT IF THE IRS DISAGREES WITH TRANSFER PRICING?



Assume a total transfer pricing tax adjustment of $10m

Additional income tax owed: $10m x 35%* =	$3.5m
Plus **non-deductible penalties** of 20%	$700,000

$4.2M + interest + US state taxes + potential double tax

20% penalties start at $5m, penalties increase to 40% at $20m

NO automatic refund of double tax

** Open tax years at pre-tax reform 35% rate*

TP DOCUMENTATION - FIRST LINE OF DEFENSE

- First, and best, opportunity to avoid an audit
- Documentation is an opportunity to explain transfer pricing
- Not filed with the US tax return, but requested under audit

Documentation generally includes the following

- Analysis of how business operates in the US and overseas
- Industry analysis
- Financial analysis of client and transactions
- Economic analysis demonstrates why transfer pricing is arm's-length (correct)
  - Often utilize 'comparable' databases

INFORMATION INCLUDED IN A STUDY

Narrations prepared through interviews – e.g.

- Which country developed the product and how?
- What cross-border R&D assistance is provided?
- Who bears risk of R&D failure?
- What process IP is utilized by related companies?

Similar interviews with sales, marketing, finance, others on both sides of the border

- **Who bears the risk of a COVID business downturn?**

IRS DISAGREES WITH TRANSFER PRICING, BUT WITH CONTEMPORANEOUS DOCUMENTATION

Assume a total taxable income adjustment of $10m

Additional income tax owed: $10m x 35%* = $3.5m

~~Plus non-deductible penalties of 20% $700,000~~

$3.5M + interest + US state taxes + potential double tax

- Draft prepared by tax return filing date for penalty protection
- Not a guarantee that tax authorities will agree with you

** Open tax years at pre-tax reform 35% rate*

NO IRS TRANSFER PRICING ADJUSTMENT?

Great, but what if you were overpaying tax in the US?

How would a foreign tax auditor react to a company overpaying tax in the US?

- What if a foreign auditor read the IRS report?

Best practice -

- **Explain transfer pricing on both sides of the border**

BENCHMARKING STUDY – AN ALTERNATIVE TO DOCUMENTATION?

TP Economic Analysis

- Benchmark profit margin target for subsidiary
- Lower risk situation/fewer resources required
- Often used for establishing transfer prices with new US or foreign subsidiaries

Example:

Adjust transfer prices to reach EBIT margin* between 5.0% to 8.2% for subsidiary

- Effectively the CPM/TNMM approach

**Earnings before interest and tax as a percentage of revenue*

Benchmark Company for Subsidiary	EBIT/Sales
Company A	16.3%
Company B	12.8%
Company C	8.2%
Company D	6.3%
Company E	5.5%
Company F	5.0%
Company G	0.3%
Company H	(3.2%)

GLOBAL AND US DEVELOPMENTS - COVID

- Governments need tax revenue, but from which companies?
- Companies “not paying a fair share” good targets
- Governments regularly audit companies incurring losses
- Companies need to manage cashflow to fund operations
- Overpaying tax not an option for cash-strapped companies

TRANSFER PRICING TAX SAVINGS

IS THERE MORE TO TP THAN COMPLIANCE?

- Transfer pricing impacts where profits and losses accrue within an organization (by country)
- TP to utilize US/foreign tax NOLs = big tax/cash savings

- Transfer pricing can be an overlooked opportunity and/or impediment for companies struggling with Covid-19
- Covid-19 tax net operating loss provisions (Carryback) can also be another valuable source of cash.

WHAT TO REVIEW?

Effectively every client filing US tax form 5471, 5472, 8858,or 8865 has a transfer pricing issue (intercompany transactions)

- Country-by-country income statement: current and past 3 years
- US tax return
- Any existing US or international TP documentation

WHAT TO REVIEW – TP SAVINGS AND RISKS

Where are profits/losses accruing in the organization?

- Intercompany transaction volumes- goods, services, royalties?
- Can changes to transfer prices be justified to save taxes?

REALIZING SAVINGS – UTILIZE TAX LOSSES

German parent with USCo subsidiary reseller

- ~$70m US revenue, purchases in Euros
- Facing market downturn

- Assume ParentCo income is **$6m @ 30% rate = $1.8m tax**

USCo P&L	2018	2019	2020	Total
US Revenue	$75.2m	$70.3m	$65.2m	$210.7m
EBIT*	$0.9m	$0	($2.5m)	($1.6m)
EBIT Margin	1.1%	0%	(3.8%)	(0.7%)

*EBIT – Earnings Before Interest and Tax

UTILIZE TAX LOSSES + REDUCE AUDIT RISKS

From an audit risk perspective:

- Would an independent distributor continue to purchase products and incur losses?

USCO Subsidiary	2018	2019	2020	Total
Sales	$75.2m	$70.3m	$65.2m	$210.7m
EBIT*	$0.9m	$0	**$0**	**$0.9m**
EBIT Margin	1.1%	0%	**0%**	**0.4%**

Utilize 2020 Losses: Reduce transfer prices to US by $2.5m

- German parent taxable income $6m - > $3.5m
- Savings $2.5m x 30% = $750k cash savings

TP CHANGES TO UTILIZE COVID-19 TAX LOSSES

Some longstanding transfer pricing polices may lead to suboptimal tax results under COVID-19

- Guaranteed cost-plus X% margin leads to large profits in one location while incurring losses elsewhere

Parent Company in Country A
($2 million loss due to COVID)
Tax NOLs

$10 million of inventory sales

Manufacturing Subsidiary in Country B
$5 million in profit - 30% tax rate
$1.50 million in tax

Parent Company in Country A
Breakeven
No Additional Tax NOLs

$8 million of inventory sales

Manufacturing Subsidiary in Country B
$3 million in profit - 30% tax rate
$900,000 in tax

- Tax Savings = $2 million x 30% tax rate = <u>$600,000 in tax</u>

BACK TO COCA-COLA

Tax Court Arguments

- By 2008 – 74% of Coke's revenues earned outside the US
- Coke and the IRS had an audit closing agreement in 1996, which apportioned profits by formula
- Coke argued that subsidiaries did bear significant marketing risks and incurred substantial costs

- IRS - the 1996 closing agreement did not address go-forward transfer pricing formulas
- IRS argued that independent bottlers bore marketing risks and Coke-US made the marketing decisions
- Why should low-risk contract suppliers earn excess profits?

WAS COCA-COLA UNDERPAYING US TAX?

TRANSFER PRICING BEST PRACTICES

Review annual profit margins of each subsidiary

- Subsidiary losses/tax NOLs = Subsidiary tax risk
- Large profits in subsidiaries = Parent tax risk
- All open tax years
- Not the final answer, but a great starting point
- Utilizing tax NOLs can be a high return on investment

IRS success in Coke can be a template for other audits

- IRS more likely to raise transfer pricing as an issue

TAX REFORM AND CARES ACT STRATEGIES

WHAT HAPPENS IF TRANSFER PRICES ARE INCREASED? BASE CASE (NO FDII)

USCo Parent
$10,000,000
Taxable income

Software Charge
→
$2m Royalty

Forco Subsidiary
$5,000,000
Taxable income

→

Forco
customers

US taxes payable
at 21% $2,100,000

Forco taxes payable
at 30% $1,500,000

- What if USCo increases the royalty by $1m?
- Alternatively - higher goods prices and service charges- similar impact

INCREASE ROYALTIES CHARGED TO SUBSIDIARY – $2M TO $3M BASE CASE (NO FDII)

	USCo Parent	Forco Subsidiary	Vs	USCo Parent	Forco Subsidiary
Royalty Charge	$2m	→		→	**$3m**
Taxable Income	$10m	$5m		**$11m**	**$4m**
Tax Rate	21%	30%		21%	30%
Taxes Payable	$2.1m	$1.5m		**$2.31m**	**$1.20m**
Taxes Payable	$3.60 million			$3.51 million	
Savings *<u>excludes</u> Foreign Derived Intangible Income (FDII) deductions*		→		→	**$90,000/annually**

FOREIGN DERIVED INTANGIBLE INCOME-EXPORT INCENTIVE

- Part of tax reform, but overlooked planning opportunity
- Difficult calculation
- Many regulations only published in 2019

What share of U.S. Company 'intangible' income is generated from exports or licensing?

- FDII income taxed at 13.125%
- Increase transfer prices = increase FDII

SAME NUMERICAL EXAMPLE
HIGHER ROYALTY = INCREASED FDII INCOME @ 13.125%

	USCo IT Parent	Forco Subsidiary	Vs	USCo IT Parent	Forco Subsidiary
FDII Royalty Income	$2m		→	$3m	
Taxable Income (After FDII Calc)	$2m FDII $8m domestic ($10m total)	$5m		$3m FDII $8m domestic ($11m total)	$4m
Tax Rate	13.125% FDII 21% domestic	30%		13.125% FDII 21% domestic	30%
Taxes Payable	$262,500 $1.68m	$1.5m		$393,750 $1.68m	$1.2m
Total Taxes		$3,442,500			$3,273,750
	Tax Savings	→			$168,750/annually

WHAT SHOULD MULTINATIONALS CONSIDER? OUTBOUND

For profitable companies:

Lower tax rates incentivize U.S. investments

- New US R&D activities = higher royalty rates
- New/Upgraded US plant = higher goods prices

Tax benefit – additional U.S. tax, lower foreign tax

- Larger deductions at subsidiaries

Under CARES Act - for loss-making companies:

- Could additional carryback NOLs generate cash?
- Potential for refunds at a 35% rate?

WHAT SHOULD MULTINATIONALS CONSIDER? INBOUND

For profitable companies - consider reducing inventory prices and royalties

- More US activities = lower transfer prices
- New US plant = lower component prices

Result- More U.S. income/ Less overseas income

- 21% rate vs. higher rate overseas
- Additional Customs duty savings?

OTHER COVID/CARES ACT STRATEGIES

CARES ACT Opportunity?

- Tax NOLs can be carried back five years - 21% or 35%(!)
- For multinationals, transfer prices drive where losses incurred
- Changes to transfer pricing may be warranted given COVID
- Numerous Foreign Tax Credit, FDII, GILTI, BEAT, 965 Repatriation complications –but could be significant cashflow

SUMMARY

- Transfer pricing rules apply to all multinationals
- Use off-the-shelf material to assess risks and opportunities
- Transfer pricing savings through utilizing tax NOLs
- Focus on cashflow optimization with COVID-19
- Transfer pricing savings with lower US tax rates
- Support transfer pricing changes through documentation

CONTACT DETAILS

ALEX MARTIN

Principal – Transfer Pricing
(313) 636-2821
Alex.Martin@kbkg.com

kbkg.com/management/alex-martin

linkedin.com/in/alexmartin/

BARNES DENNIG
Accounting • Tax • Business Insight

ELLEN T. JURAM, CPA

Director
513.241.8313
ejuram@barnesdennig.com

barnesdennig.com/team-member/ellen-t-juram-cpa/

linkedin.com/in/ellen-juram-69815a27/