



# Current Events in U.S. Transfer Pricing

October 7, 2010

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# **Global Supply Chain & Economic Substance**

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## Global Supply Chain - 2010

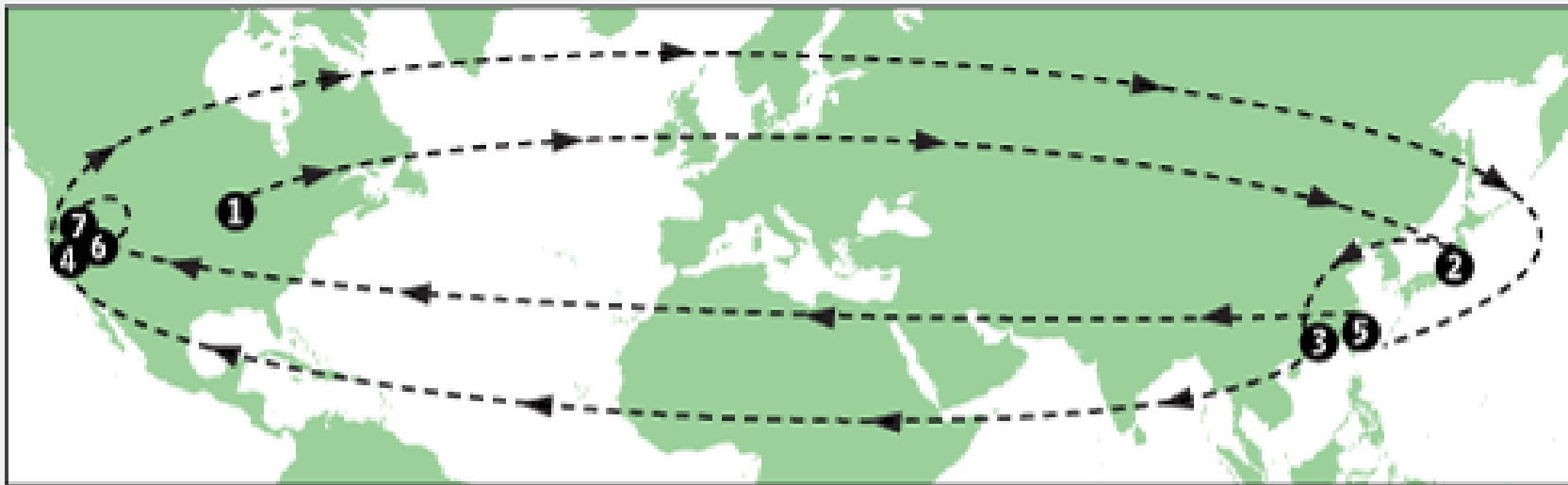
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*“Looking at a company in the context of its supply chain and stakeholders renders a much fuller view, a holistic image of activities, a seamless chain of capabilities or know-how, both its own and that of the organizations with which it is allied. Like the world around them, these capabilities and the relationships among them are constantly changing and evolving.”*

– Charles Fine, *Clockspeed*, 1998

# Global Nature of Supply Chains

## Life of a DVD Player | How the tech supply chain makes the world's gadgets



1

Minnesota-based **Best Buy** decides how many DVD players it wants, orders from Toshiba...

2

**Toshiba** tells factories-for-hire in China to crank up production ...

3

Those Chinese **factories-for-hire** order chips from Zoran Corp. ...

4

**Zoran** tells its own subcontractors, including TSMC, to get busy making more chips...

5

**TSMC**, in Taiwan buys factory equipment from Applied Materials ...

6

In California, **Applied Materials** shops for specialty machine-tool services...

7

Machine-tool firm **D&H Manufacturing**—at the end of the chain—mills aluminum blocks for Applied.

# Supply Chain Model

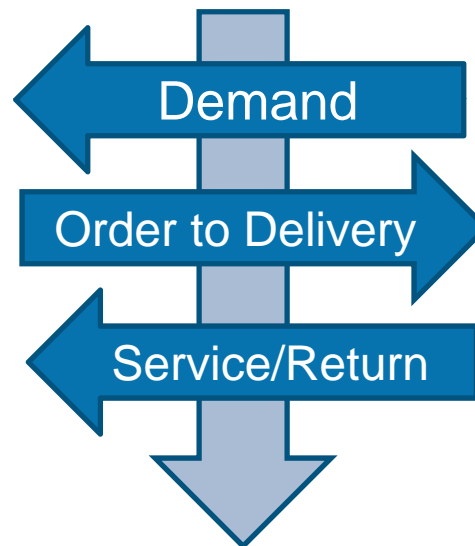
## Old Supply Chain Model



## New Supply Chain Model

- **Ecosystem**

- Suppliers/Supplier's Suppliers
- Customers/ Customer's Customers
- Third-Party Service Providers
- Internal Stakeholders



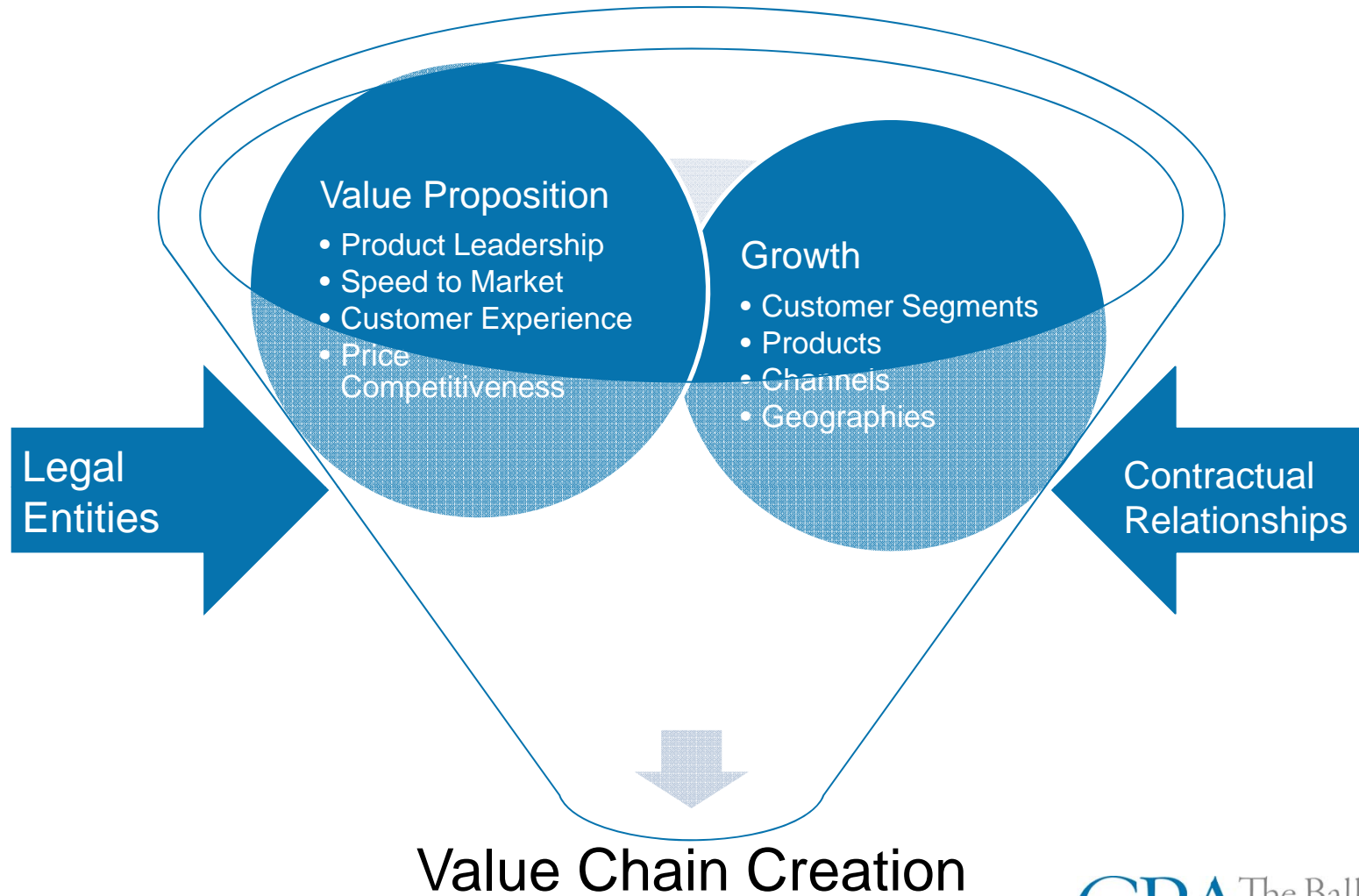
- **Flows/Transactions**

- Physical Shipments
- Services
- Digital
- Information
- Financial
- Legal

Adapted from Accenture, "Seven Imperatives for Achieving Dynamic Supply Chains"

# Value Chain Creation

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# Economic Substance

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- Economic Substance for Transfer Pricing Required.
  - Section 482 Regulations:
    - Transfer pricing will be respected if it is consistent with the economic substance of the underlying transactions.
    - In evaluating economic substance, the actual conduct of the parties is given the greatest weight.
    - The IRS will impute a contractual agreement between the controlled taxpayers consistent with the economic substance of the transaction.
  - Interim Guidance under Codification of Economic Substance Doctrine:
    - Section 1409 Health Care & Education Reconciliation 2010 Act .
    - Section 7701(o) and related penalty sections (incl. Section 6662).
    - For transactions entered into on or after March 31, 2010.

# A Proactive Response

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- ***What is the best strategy to balance Tax and Transfer Pricing Planning & the Economic Substance Doctrine requirements?***
  - The most defensible tax and transfer pricing planning is driven by an alignment with supply chain and organizational change.
    - Identify the strategy driving the organizational change.
    - Confirm the basis for organizational change.
- **According to our CRA Change Management Experts:**
  - Organization changes occur to deliver results.
  - Results need a transparent link between what employees are doing and what the company is trying to achieve.
  - A focus on action (*i.e.*, what employees actually do) over abstract ideas (*i.e.*, corporate culture) results in a simplified change management program.
    - Information that is likely already available to support the economic substance.
    - Conduct fact-finding interviews; generate a well-written report addressing the selected strategy as well as the alternatives to the strategy to satisfy the OECD and the IRS.

# Acquisitions: A Special Breed of Business Change & Economic Substance

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- Beyond the current financial turbulence, successful companies will continue to use M&A to grow their positions but costs are likely to rise.
  - Companies with significant cash are already engaged in higher deal activity.
- **Successful tax and transfer pricing planning and implementation will enable MNCs to retain the deal value.**

# Risks: Uncertainty is the Mother of Inventory...

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- The global economic recession has forced companies to reduce capacity either within their own supply chains or in their supplier base.
- During the downturn, companies have managed excess inventory issues and now struggle with less flexibility in their speed to market in a more constrained supply chain.
- As demand begins to grow, companies will now be challenged by cautiously reviving their supply.
  - How will transfer pricing be affected?
    - Current methodologies and the accounting of inventory risk
    - Current intercompany agreements and inventory terms
    - Decision-making processes as responsibilities adapt to growth

# Essential Elements to a Successful Supply Chain Implementation

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## Tax

- Transfer Pricing
- Value Added Tax
- Customs
- Principal Substantiation
- CFC Rules (Subpart F)
- Permanent Establishment
- Intangible Property Migration
- Conversion Gains
- Expatriate Taxation
- Domestic

## Operational

- Information Technology
- Accounting
- Change Management
- Works Council/Unions
- People Movement
- Performance Measurement



# Current Events in U.S. Transfer Pricing

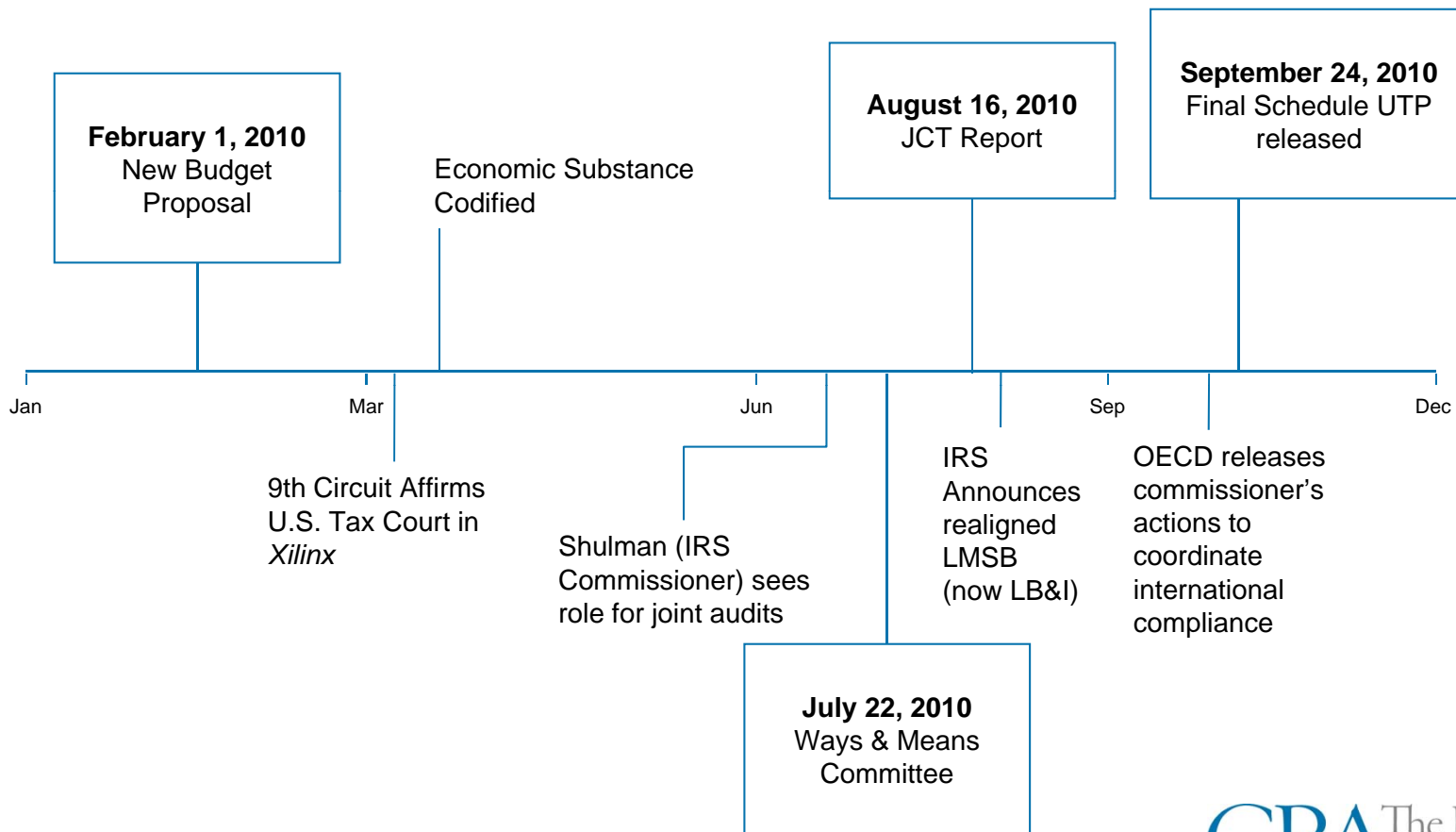
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# 2010 Highlights in Transfer Pricing

- 2010 has brought an onslaught of opposition and scrutiny in transfer pricing.



# Ways & Means Committee Hearing

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- July 22, 2010.
- Full committee hearing on “Transfer Pricing Issues.”
- Purpose was to gauge the extent to which “transfer pricing poses a serious problem to our international tax laws.”
- The Joint Committee on Taxation (JCT) prepared a study to address this question and was a focal point of the hearing.
- Discussion also focused on identifying proposed solutions to address the perceived issue.

# Genesis of Congressional Hearings on TP

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*Transfer pricing is a serious issue. It has emerged over time to pose a challenge to the enforcement of U.S. tax laws. According to reports and media stories, multinational companies are potentially gaming the current system to shift assets and funding within foreign-based entities to avoid paying U.S. taxes.*

- House Ways and Means Chairman, Sander Levin

# Genesis of Congressional Hearings on TP

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*...multinationals avoid taxes and shift the burden of paying for our national security, our homeland security, and other public services onto small businesses and family taxpayers who play by the rules and cannot engage in these kind of international shenanigans.*

- Congressman Lloyd Doggett - Texas

# Arguments for Formulary Apportionment

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- Michael Durst (formerly with the IRS) speaks in favor of formulary apportionment.
  - Replace the arm's-length standard as part of more comprehensive tax reform.
  - Fix the TP rules and include offsetting business tax relief.
  - Indicated that the arm's-length standard helps create the “spectacle” of income shifting.
  - Intercompany agreements do not reflect meaningful economic bargaining.

# Arguments for the Arm's-Length Standard

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- International Tax Review's Global TP Forum in Amsterdam (September 2010).
  - The arm's-length standard remains the only viable option.
- Steven Shay (Treasury Assistant Secretary, International Tax Affairs).
  - The Administration supports the current arm's-length standard under Section 482.
  - Regarding formulary apportionment, the Administration is not prepared to state a position.
- The JCT Report.
  - While the effectiveness of the arm's-length standard is sometimes debated, it is still important.
  - Modifications to the arm's-length standard could disrupt relations with U.S. trading partners.
  - Proposals outlined in the JCT report are consistent with the arm's-length standard.

# Arguments for the Arm's-Length Standard

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- While it is not perfect, the arm's-length standard is an internationally recognized and used method.
- A system based on formulary apportionment may:
  - Produce a large tax increase for multinational enterprises, without a material offset.
  - Will not create a “tax windfall.”
- However, formulary apportionment is gaining traction.
  - Experts prepare proposals.
  - Headlines continue to put TP in a negative light.
  - TP has even attracted the attention of the President.

# FY11 Federal Budget Proposals

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- Issued February 1, 2010.
  - Included significant international tax reform proposals, including transfer pricing.
- Provisions would generally be effective beginning after 2010.
- “American know-how, reputation, and trained personnel are assets that should not be shipped overseas without a higher return on those assets from tax revenues.”
- Based on revenue estimates, between 2011 and 2020, approximately \$16.7B is possible by changing some TP rules.

# FY11 Budget Proposal on Transfer Pricing of Intangibles

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- Scrutinize IP transfers by U.S. persons to related CFCs.
  - If the CFC is subject to a lower ETR and circumstances indicate that there is excessive income shifting, the “excessive return” will be treated as Subpart F income.
    - Effective for tax years beginning after December 31, 2010.
  - Proposal is estimated to raise \$15.5 billion in revenue over 10 years.
- Clarify/Expand the definition of IP to include:
  - Goodwill;
  - Going concern value; and
  - Workforce in place.
  - As part of the clarification of IP, the Commissioner may also:
    - Consider realistic alternatives; and
    - Aggregate multiple IP if that would achieve a more reliable result.
  - Proposal is estimated to generate \$1.2 billion in revenue over 10 years.

# The JCT Report – Overview

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- Published August 16, 2010.
- Analyzes the budget proposal tax provisions.
- Estimates lower revenue impacts than stated by the Administration.
  - Tax on excess returns would raise \$10.2B over 10 years (versus \$15.5B).
  - Limitation on income shifting would raise \$474M over 10 years (versus \$1.2B).
- While the effectiveness of arm's-length transfer prices is debatable, the proposal avoids the debate by addressing excessive income shifting through Subpart F.
  - Not through any direct changes to the Section 482 TP rules.

# The JCT Report – Overview

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- Mentions “economic substance” in relation to realistic alternatives.
  - “The realistic alternative principle is reflected in Treasury regulations, which provide that the Commissioner will evaluate the results of a transaction as actually structured by the taxpayer unless its structure lacks economic substance, but that the Commissioner may also consider the alternatives available to the taxpayer in determining whether the terms of the related-party transaction would be acceptable to an unrelated-party taxpayer faced with the same alternatives and operating under comparable circumstances.”

# What We Can Discern

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- Resources are being devoted to enhance enforcement of current rules:
  - Increases importance of having TP documentation in order.
  - Taxpayers should ensure that all transactions are supportable from an economic substance perspective.
- Legislation may change the dynamics of TP, but this is highly uncertain and dependent on political events.
- If the perceived effectiveness of TP rules is not increased, formulary-based approaches may continue to gain traction.

# What's Next?

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- The Economic Recovery Advisory Board (PERAB) Report published on August 27, 2010.
  - Outside advisory board and is separate from the Administration.
  - Engaged to provide “helpful advice” to the Administration and Congress.
  - Does not endorse any specific proposals.
- IRS has developed a schedule requiring certain business taxpayers to report uncertain tax positions (UTPs) on their tax returns.
  - Notice of Proposed Rule Making (NPRM) published September 9, 2010.
  - Requires a corporation to rank all reported U.S. federal income tax positions.
  - Five-year phase-in for filing the schedule:
    - Corporations with \$100 million or more in assets will file beginning with 2010 tax years.
    - Those with \$50 million in assets beginning two years later (2012 tax year); and
    - Those with \$10 million in assets beginning two years after that (2014 tax year).
  - The IRS will review the 2010 forms and make modifications as necessary, with a final rule to be issued by the end of 2010.