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What You Really Need To Know About Transfer Pricing

The Editor interviews ***Patricia Gimbel Lewis****, Member of Caplin & Drysdale, Chartered's Washington, DC office.*

Editor: You have received fine recognition for your work in international tax law from Chambers from 2008 through 2012 and from Legal Media Group in 2009 and 2011-2012. Please tell our readers about your recent receipt of the Euromoney Legal Media Group's Americas Women in Business Law Award as "Best in Transfer Pricing" and the reasons for their choice.

Lewis: The awards reflect comprehensive analysis by Legal Media Group on women lawyers in various practice areas. This is the first time LMG has made regional awards for women in business law in North America. The awards are based on their own research. I can only conjecture as to their reasons for selecting me based on certain aspects of their interview with me. They may have been struck by the efforts I have made throughout my career to design ways to simplify the administration of our tax system with respect to otherwise complex tax situations. Most recently my efforts revolve around the use of "safe harbors" in transfer pricing. This same theme dates back to a project I worked on almost 20 years ago for the IRS Commissioner's Advisory Group regarding the simplification of tax laws through IRS administrative input during the legislative process, along with other tax simplification proposals in the transfer pricing area, e.g., relating to cost-sharing agreements, and long ago in the area of pension plans.

Editor: As you mentioned, one area of your concentration in international tax law is that of transfer pricing. Please provide us with a definition of transfer pricing and whether it impacts goods, services and intangibles.

Lewis: Transfer pricing impacts all cross-border transactions of any type between related parties, that is, companies that are a part of a commonly controlled global multinational group. Transfer pricing means the prices at which these cross-border transactions are conducted. The tax laws are involved in ensuring that the prices at which these transactions take place lead to a fair allocation of the trading group's profit among the countries involved. The purpose is to ensure that those cross-border, related-party prices are "arms length" in the sense that they are roughly equivalent to the prices that would be paid if the parties were not related.

Patricia Gimbel Lewis

Editor: What general rule should be used in designing an optimal transfer price for goods and services?

Lewis: There is no one general rule. I think the basic concept underlying the approach by businesses is to design transfer prices that are balanced in three areas: in terms of governmental fiscal interests of the various countries involved, the business interests of the various parts of the business that are involved, and administrability, from both corporate and governmental perspectives. Ideally, you would want to design transfer pricing arrangements that permit the parties to focus more on their business than on its tax consequences. And of course you also want to design a system that minimizes the risk of double taxation, which can result when the countries on either side of the transaction have different views as to the proper price.

Editor: What benchmarks are proper for setting a transfer price, such as market prices of comparable goods, services, intangibles, etc.?

Lewis: While market price is a great benchmark, unfortunately it is seldom available. Unless you are dealing in commodities or services for which there are published prices, it may be difficult to find an exact comparison in the marketplace for the specific goods that are being transferred, including the terms of the transaction, or a way to adjust a surrogate to make it equivalent. (These are called "comparable uncontrolled prices," or "CUPs.") So other methods have to be devised, and they're usually based on profitability of "comparable" sets of transactions or public companies. As a practical matter, that's the most available benchmark – it's not anywhere near as perfect as a comparable market price would be, but it's the best there is.

Editor: What agencies enforce the various systems of transfer pricing, both domestically and internationally?

Lewis: In all countries that have transfer pricing rules, the tax administration enforces the pricing system. In the United States, that is the IRS, and other countries have their equivalent of the IRS. There is a special feature to transfer pricing with countries with which we have income tax treaties that adds another layer of complexity – but potential benefit – and that is the Competent Authority Process. Under our treaties the "competent authority" of each of the treaty partners is authorized to confer with its counterpart to try to avoid double taxation of taxpayers where one country has made a tax adjustment that has a ripple effect in the other country. The prime subject for this process is transfer pricing, so the competent authorities of the treaty partner tax authorities also play a critical role in transfer pricing. The Competent Authority Process may or may not be lodged in the same agency or part of the agency that handles the transfer pricing enforcement (i.e., audit). In the United States, all aspects of transfer pricing administration have recently been brought under the same roof in the IRS in an effort to centralize expertise and enhance consistency and focus in application of the transfer pricing rules.

Editor: In the case of imports from a Chinese subsidiary of a U.S. company, for

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example, does Customs play a role in determining fair pricing?

Lewis: If one thinks about transfer pricing as the main course, a side dish is Customs' rules for determining the amounts on which customs duties are imposed. In addition, there are anti-dumping rules, administered by another agency, which also address cross-border transfers. Both customs and anti-dumping rules have different perspectives and standards and may test pricing at different levels from those used for transfer pricing determinations. I have had cases where there were simultaneously transfer pricing audits, Customs' audits and dumping cases, and the intersection was not at all congruent. There are certain statutory relationships between Customs' duties and tax, but as a general matter they operate independently. For many years there has been an effort by taxpayers to seek more consistency between tax and Customs, but it's a very difficult area to coordinate. One idea is to enable taxpayers to rely on advance tax-based pricing analyses or agreements to support their Customs' pricing, but coordination is slow in coming.

Editor: Tell us about your role in negotiating advance pricing agreements (APAs) between taxpayers, the IRS and foreign tax authorities.

Lewis: My particular role is that of an orchestrator of a very complex piece of music. There are many parties involved – on the taxpayers' side you work with people in various parts of the global business group (both functionally and geographically) as well as consultants, economists and accountants; and then there are teams involved, at various levels, in the two governments. There are many things to coordinate. I should distinguish between the orchestrator (my firm) and the conductors, who are the tax authorities that make the ultimate decision. My job is to coordinate and strategize as to how to make all of these players work together in a very transparent, cooperative and mutually beneficial way. Advance pricing agreements are intended to be cooperative, not adversarial, exercises, and that's the beauty of them when they work correctly!

Editor: How would you actually define an advance pricing agreement?

Lewis: It's an agreement between taxpayers and one or more tax authorities on a methodology for transfer pricing between related enterprises, in the form of a contract that can be relied upon by all parties for pricing these transactions for a number of years, mostly forward but also usually covering some completed years as well, due to the length of the process. The APA buttons down the pricing to avoid tax audits, and if it's done between multiple countries, there's no double taxation. Most typically APAs are bilateral, which means they involve the IRS and another country, but they can alternatively be done just with the IRS to prevent audits by the IRS. However, such a so-called unilateral agreement doesn't prevent double taxation by another jurisdiction, though if double taxation ends up being proposed, you can resort to the Competent Authority Process if a treaty country is involved. Generally, governments prefer bilateral or multilateral agreements so that you solve your problems with all of the affected tax authorities at one time.

Editor: Do we have these agreements throughout the world? How limited are they?

Lewis: They're now very global. The concept took root about 20 years ago with the first major program started by the IRS. Since that time some 50 developed countries in the world have initiated similar APA programs. On July 1, India will institute an APA program for the first time, which has the potential to be quite significant as there are many double-taxation controversies with India.

Editor: Why do you suggest that the IRS should consider allowing small companies to elect safe harbors in dealing with transfer pricing?

Lewis: That's simple. The proliferation of transfer pricing rules and their enforcement around the world threatens to strangle our tax system and that of other countries in trying to administer these rules. Without safe harbors two things are becoming increasingly evident: the burden on the tax administrations in enforcing the rules is overwhelming, and the burden and challenge for taxpayers to comply with the panoply of rules is also overwhelming. In order to allow the tax authorities to focus on the hard and important cases while still generating appropriate tax revenues, I think you have to reallocate everyone's resources by enabling some companies to use arm's-length-based safe harbors. In my view, use of a safe harbor would be just as appropriate for a large, but not complex, transaction as for a small, but not complex, transaction. As a political matter, in terms of instituting safe harbors, there may be more sensitivity to covering large transactions, but theoretically the same considerations should apply.

Editor: Is there any reason why companies should not seek out tax havens for manufacturing or providing services so long as they conform to the laws of the country in which they operate? Should they be extremely careful where transfer pricing in a lower-tax venue is concerned?

Lewis: As to your latter question, yes, for sure. As to your first question, it's not a matter of only conforming to the laws of the country in which they conduct a particular activity, but also the laws of the country in which they are based. There are two sides to every transfer pricing transaction: one is the tax haven side in your hypothesis and the other is the non-tax haven side, like the U.S. I'd pay much more attention to the U.S. rules than I would to the tax haven rules since tax haven rules generally don't impose much tax and aren't very complex, but the U.S. in that context is much more concerned about whether the prices are fair. That's where the stakes are highest for the caompanies. The IRS is legitimately focused on tax haven transactions because of the potential for abuse on a large scale. The biggest area of IRS transfer pricing enforcement these days is the transfer of intangible property, such as patents or other forms of technology, to tax haven countries, because it's very hard to determine the correct price. However, if valuable intangibles exit the country at less than an arm's length price, they have the potential to generate a lot of income that isn't captured by the U.S., and the IRS knows it. That's why one has to be careful in these transactions. Focus on the U.S. side in that pattern – that's the law that really matters in terms of exposure.

Editor: What cautionary advice would you give our readers who counsel their companies regarding their activities in overseas markets?

Lewis: Pay attention to transfer pricing. It's everywhere, and as you noted when we started this discussion, a lot of people aren't familiar with it and thus may not be sensitive to the implications of cross-border transactions from a tax perspective. It's unfortunately not at all uncommon for major transactions to occur without anyone thinking about the transfer pricing implications. Think ahead! Get your tax department involved early and often in transactions or business relationships that cross borders. The other guide is, simply, to be fair and consistent around the world in pricing your cross-border transactions. Don't deviate for inappropriate tax-planning purposes because demonstration of a consistent methodology is often the savior where transfer pricing is concerned. Having fair methodologies applied reasonably and uniformly around the world is the best advice I can give. And always consider the potential benefits of APAs for your company.