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Transfer Pricing:

A Critical Tax Management Tool for German Multinationals with U.S. Affiliates[1]

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German multinationals operating with United States affiliates increasingly must incorporate transfer pricing to effectively manage their global businesses and maximize shareholder value. Transfer pricing is the price paid in transactions that take place among related party affiliates. These intercompany transactions typically take the form of a sale of goods, a license or sale of intangible property (e.g., technology, know-how, brands), the provision of services or intercompany financing.

Transfer pricing, in the context of international tax, allocates income and expense among members of a controlled group in cross-border transactions. This area has been subject to increasing controversy as governments seek to protect their tax base from erosion. Under the OECD Transfer Pricing Guidelines, the Arm's Length Principle (ALP) dictates "transactions should be valued as if they had been carried out between unrelated parties, each acting in his own best interest." Although most countries have adopted it, the ALP is subject to interpretation by national governments. These interpretations often yield significant controversy.

German multinationals operating in the U.S. must closely monitor their transfer pricing compliance for several reasons. First, the Internal Revenue Service (IRS) considers transfer pricing enforcement a key revenue generating area. In 2004, the IRS issued a Transfer Pricing Compliance Directive. The Directive instructs IRS agents to issue a Transfer Pricing Information Data Request (IDR) at each audit's inception.[2] German multinationals unable to provide such documentation may be subject to transfer pricing disputes with the IRS. Transfer pricing disputes with the IRS may lead to transfer pricing adjustments (potentially resulting in double taxation) and non-deductible transfer pricing penalties and interest.

Second, the U.S. levies a high corporate tax rate. When Japan

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reduced its corporate tax rate on business income between national and local taxes from 39.8 percent to 36.8 percent on April 1, 2012, the combined U.S. federal and state corporate rate of 39.2 percent became the highest in the world.[3] Given this, improperly monitored U.S. transfer pricing compliance may have significant tax consequences. For example, assume a multinational's U.S. domiciled affiliate bears a U.S. effective tax rate (ETR) of 39 percent while its German parent bears a 30 percent ETR. Thus, the multinational's ETR differential between the affiliates is 9 percent. If the U.S. affiliate's recognized income exceeds the arm's length range by $12 million, the multinational would pay $1 million more of tax than required.[4]

How can German multinationals mitigate their potential transfer pricing risks, while efficiently minimizing their global ETRs?
The first step is a functional analysis to determine the functions, risks, and assets of each legal entity along a multinational's entire supply chain. Intangible assets such as patents, trade secrets, know how, and trademarks are frequently a multinational's key profit drivers. The functional analysis will identify the legal and economic owners of a multinational's intangible asset portfolio.

Second, we characterize the multinational's affiliates as profit centers, revenues centers, or cost centers. Profit centers typically own a multinational's non-routine intangibles and manage the consolidated entity's significant risks. Revenue centers typically perform region specific, marketing and distribution activities. Cost centers perform manufacturing and service activities, although distributors may, at times, perform after sale services activities as well.

Third, we identify comparable benchmark data and evaluate and select transfer pricing methods. U.S. transfer pricing regulations stipulate a "best method" rule. This rule requires that we select the transfer pricing method(s) that, "given pertinent facts and circumstances, provide the most reliable measures of an arm's length result".[5]

German multinationals must attend to their transfer pricing policies to manage their ETRs, especially with respect to their U.S. affiliates. Proactive transfer pricing compliance policies will service this imperative, mitigating risks associated with transfer pricing disputes, transfer pricing assessments, and double taxation, as well as potential penalties and interest. WTP has assisted many German multinationals with U.S. affiliates design, implement, and document sustainable transfer pricing policies. These companies have improved after-tax, free cash flow and increased shareholder value. ■

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2 See: http://www.irs.gov/Businesses/International-Businesses/Transfer-Pricing-Compliance-Directive.

3 We note actual state corporate income tax rates range from those states that levy no corporate income tax to those whose rates approach 10%.

4 $12 million x 9% = $1.08 million net tax overpayment.

5 Treas. Reg. § 1.482-1(c)1.