Transfer pricing in the context of international M&A

Being proactive pays off

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After a lull following The Great Recession of 2008, mergers and acquisitions (M&A) have returned to prominence in today's economy. M&A transactions are used by multinational enterprises (MNEs) to integrate vertically or horizontally to achieve operational economies of scale, broaden their funding base, enter new geographic markets, broaden product offerings or achieve cost and operational synergies. As with any significant business transformation event, the implications of transfer pricing on international M&A bring both opportunities and risks.

An international M&A transaction can offer the MNE a unique opportunity to assess and integrate the legacy transfer pricing policies of the acquirer and the target. Each stage of the transaction — planning and due diligence, mid-transaction, and post-integration — should include significant efforts to evaluate the transfer pricing strategy and risk profile of the combined enterprise, and integrate transfer pricing into its operations and reporting systems.

The role of transfer pricing

Transfer pricing plays an important role in many key business operations, including R&D, procurement, manufacturing, distribution and other supply chain functions; as well as shared services, management services and other "head office" functions, many of which may be subject to integration efforts as part of the M&A transaction. Furthermore, as the combined enterprise integrates products and services and deploys intangible property (IP), transfer pricing considerations must be part of the IP integration efforts.

Arm's length transfer pricing

Transfer pricing must also be considered when evaluating the projected cash flows of the combined enterprise. The application of the "arm's length" principle to intercompany transactions is the standard under the tax laws of almost all developed economies. For this reason, the projected operating results of the combined enterprise cannot present a realistic picture of the individual legal entities or operating units unless arm's length pricing has first been "baked into" the results. Similarly, any discounted cash-flow analysis of the combined enterprise must be based on cash flows that incorporate arm's length transfer pricing. Finally, any redeployment or realignment of IP within the legal entity structure of the combined enterprise, and the resulting projected operating results of the licensor and licensee operating units, should be based on arm's length transfer pricing. A departure from the arm's length standard will likely lead to exposure to tax adjustments, potentially causing the business to face tax controversy, double taxation,[1] and/or non-deductible interest and penalties.

Arm's length transfer pricing and debt financing

Transfer pricing considerations can also influence how international M&A transactions are funded, particularly when debt financing forms a material part of that funding. Debt financing often involves the imposition of debt covenants on the combined enterprise, including covenants that are tied to cash flows that are generated by the combined enterprise or by individual operating units. As noted above, both the projected and actual cash flows generated by any particular operating unit within the enterprise must incorporate the arm's length transfer pricing standard. Failure to do so may result in unexpected pressure on the covenants down the road when "actual" calculations using arm's length transfer pricing amounts don't support the minimum debt covenant requirements.

Don't forget legacy tax audit experiences

International M&A transactions provide the opportunity to integrate the legacy transfer pricing policies of the acquirer, the target and the business case to create a new, consistent policy for the combined enterprise. While integrating, MNEs must

[1] Double taxation occurs when the same income is taxed by two fiscal authorities. While it may be possible to obtain relief from double taxation through the Competent Authority process (for countries with tax treaties with the U.S.), such procedures often entail significant costs and may take several years to resolve.

[2] As of this article's publication date, the United States has the highest statutory corporate income tax rate in the industrialized world.

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consider the legacy tax audit experiences of each company, and in each material jurisdiction; any prior non-traditional transfer pricing mechanisms in place, such as Competent Authority proceedings or Advance Pricing Agreements (APAs) still in force; and any comparable transactions or comparable companies identified during prior benchmarking exercises. An extreme example of this is a corporate inversion/merger, a technique under which a U.S.-headquartered company merges with a foreign entity and becomes foreign-headquartered as a result. This technique reduces the income of the merged entity subject to high U.S. tax rates by moving much of the future foreign profits associated with the merged MNE's synergies and growth outside the U.S. tax net.[2] There are ongoing discussions in Congress and the White House today aimed at dissuading U.S. MNEs from inverting.

The risks of waiting

For all of the reasons above, arm's length transfer pricing has become a key input in all three international M&A transaction stages. MNEs that wait until after the transaction has closed to address transfer pricing do so at the risk of sub-optimizing the risk management, cash flow and funding aspects of the combined enterprise. Our experience with clients over the years has demonstrated that integrating transfer pricing with M&A should happen during each of the three stages of the M&A process.

Because MNEs are widening the global scope of their operations and supply chains, while tax authorities around the world attempt to claim their "fair share" of taxable income, MNEs are at increasing risk of transfer pricing controversy, double taxation and non-deductible penalties. These risks are multiplied when two different legacy companies are combined into a new enterprise.

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Transfer pricing activities by stage

While the lists below are not exhaustive, they provide an idea of the transfer pricing activities that can and should take place during each stage. These activities can be carried out by a team comprised of external advisers and in-house transfer pricing specialists. Ideally, in-house professionals and advisers from each of the merging/combining companies will be able to exchange relevant information during the international M&A process so that the joint efforts of the teams will yield early and useful planning results.

- **Planning/due-diligence stage:**
  - Review the transfer pricing policies and audit experiences of each of the legacy enterprises
  - Review intercompany transaction agreements among affiliated companies
  - Review legacy APAs or Competent Authority appeals
  - Review third party and internal "comparables" and benchmarks adopted by each legacy enterprise
  - Review operating and cash-flow projections for the combined enterprise to evaluate the application of the arm's length principle to such projections
  - Review debt covenants for the combined enterprise that may be affected by transfer pricing
  - Identify existing IP and anticipated future IP of the merged enterprise — including synergies and goodwill[3]
  - Identify potential transfer pricing planning opportunities
  - Prepare a due diligence transfer pricing report incorporating conclusions and recommendations to address potential transfer pricing risks and opportunities
- **Transaction stage:**
  - Review projected changes to combined business operations, including head office functions, supply chain, procurement, manufacturing and distribution, shared services, R&D and IP ownership and deployment processes
  - Value tangible or intangible assets as required under the transaction
  - Prepare recommendations with respect to the application of transfer pricing policies and principles to contemplated operational changes
  - Formulate a recommended global transfer pricing strategy for the combined enterprise
- **Post-acquisition (integration) stage:**
  - Design a detailed transfer pricing structure that enhances free cash flow and shareholder value of the combined entity
  - Provide transfer pricing assistance in restructuring business operations, including head office functions, supply chain, procurement, manufacturing and distribution, shared services, R&D, and IP ownership and deployment processes
  - Support the operational implementation of transfer pricing policies, including General Ledger reporting, budgeting/financial planning and management reporting integration
  - Assist with evaluating and quantifying ASC 740-10 (Uncertain Tax Position) reserves relating to transfer pricing
  - Support counsel or the law department in preparing intercompany agreements with affiliates
  - Provide support in securing or amending APAs
  - Prepare transfer pricing documentation for intercompany transactions

[3] For federal income tax purposes, IP is subject to a specific definition under Internal Revenue Code Section 936(h)(3(B). The term "intangible property" means any (i) patent, invention, formula, process, design, pattern, or know-how; (ii) copyright, literary, musical, or artistic composition; (iii) trademark, trade name, or brand name; (iv) franchise, license, or contract; (v) method, program, system, procedure, campaign, survey, study, forecast, estimate, customer list, or technical data; or (vi) any similar item, which has substantial value independent of the services of any individual. This definition does not include goodwill, going concern value, workforce-in-place or other items that might be considered intangible property in the broader sense.

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The benefits

At the same time, international M&A transactions provide the opportunity to integrate the legacy transfer pricing policies of the acquirer and the target. They also create the business case to create a new, consistent transfer pricing policy for the combined enterprise to maximize after-tax free cash flows and shareholder value.

Even if Congress or the Obama administration is successful in dissuading inversions, there are myriad transfer pricing planning opportunities associated with international M&A. Identifying and addressing these risks and opportunities requires the expertise of transfer pricing specialists who are able to understand and apply the new company's strategic goals to the transfer pricing aspects of the combined enterprise. Doing so early enough and at each stage in the process, while there is sufficient planning and integration flexibility, will enhance the MNE's ability to optimize its transfer pricing risk management and sustainable planning structures. By following the guidelines outlined in this article in a proactive process that proceeds in parallel with the stages of the international M&A transaction, MNEs can more effectively address transfer pricing risks, and planning opportunities can be identified and implemented in a timely fashion. ■

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Learn more from Guy Sanschagrin at the Tax Conference

Catch Sanschagrin in action as he provides more insight on transfer pricing at the 60th Annual MNCPA Tax Conference, Nov. 17-18 at the Minneapolis Convention Center. His session, *Transfer Pricing: International Trends, Controversy and Strategy,* takes place Tuesday afternoon.

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