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Enrique heads the Latin American Transfer Pricing practice for **Deloitte & Touche** in the Mid-America Region and he also leads the Dallas Transfer Pricing practice.

His transfer pricing engagement experience includes planning, advocacy and documentation projects for dozens of large multinational clients in diverse industries including telecommunications, software, electronics, petrochemicals, construction materials, food products and consumer goods. Enrique has specific experience in the following areas:

- Transfer pricing analysis for Section 482 compliance in multinational transactions;
- documentation for Section 6662 compliance;
- economic analysis and documentation for compliance with transfer pricing regulations in Mexico, Canada, UK and Australia in coordination with local experts;
- extensive work in determination of compensation levels for management fees for services, and royalty rate calculations for licensing of intangible assets;
- economic analysis for strategic applications beyond regulatory compliance, such as executive compensation, acquisitions, contract negotiations and financial transactions;
- Advance Pricing Agreements;
- economic analysis for Japanese *sogo shosha* operations

Enrique received a **B.Sc.** from Texas A&M University in 1987 and an **MBA** from The Curtis Carlson School of Management in 1995. He has over four years of specialized experience in transfer pricing and eight years of business management experience prior to that with Pillsbury/GrandMet in several positions and with Northwest Airlines as a Senior Strategic Analyst.

He is a frequent speaker on the topic of transfer pricing, and a board member of several nonprofit organizations, including The United States – Mexico Chamber of Commerce, The Dallas Council on World Affairs, the Dallas Summer Musicals, The Mexican Cultural Center and The Anita N. Martinez Ballet Folklorico.

THE ROLE OF TRANSFER PRICING IN INTERNATIONAL TRADE

Testimony before

The Trade Deficit Review Commission

Submitted by Enrique MacGregor

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I. Introduction

Transfer pricing decisions are made frequently by multinational corporations. When a company transfers goods, performs services, or licenses the use of intangible property to an affiliated entity, this transaction is regarded as a sale. The compensation paid in intercompany transactions is the transfer price.

The globalization of the World's economy has increased the volume, magnitude and complexity of transfer pricing transactions across international borders. Although transfer pricing policies are generally used as a strategic tool by management to achieve non-tax business objectives, the arbitrary use of transfer pricing for tax evasion purposes has received increased attention by tax authorities and has resulted in the development of transfer pricing legislation by most industrialized countries.

Improper management of transfer pricing can lead to double taxation, penalties and costly litigation. Transfer pricing problems arise when governments assert claims to the tax profits earned in the same transaction within each of their jurisdictions. It is important for the development of international trade that the rules and principles applied on each side of a transfer pricing transaction be compatible, and that the differences that arise in different countries are resolved without significant disruption to the business.

II. Transfer Pricing Principles**A. The Arm's Length Standard**

Virtually every major industrial nation uses the arm's length standard as its frame of reference for transfer pricing. The fundamental principle embodied in this standard is a market-based valuation of transfer pricing transactions. To determine arm's length pricing, a tax authority generally looks to comparable selling prices set by unrelated buyers and sellers in similar selling environments.

B. Transfer Pricing Methods for Tangible Property

To satisfy the U.S. requirements, the arm's length amount charged in a controlled transfer of tangible property must be tested under one of the following methods: comparable uncontrolled

price method, resale price method, cost plus method, comparable profits method, profit split method, or unspecified methods.

The comparable uncontrolled price method compares amounts charged in controlled transactions with amounts charged in comparable third-party transactions. Comparable sales may be between two third parties or between one of the related parties and a third party. The CUP method is generally the most reliable measure of arm's length results if transactions are identical or if only minor, readily quantifiable differences exist.

The resale price method evaluates whether the amount charged in a controlled transaction is at arm's length by reference to the gross margin realized in comparable uncontrolled transactions. The resale price method is most often used for distributors that resell products without physically altering them or adding substantial value to them.

The cost plus method compares gross margins of controlled and uncontrolled transactions. The cost plus method is most often used for manufacturers selling to related parties.

The comparable profits method evaluates whether the amount charged in a controlled transaction is at arm's length by comparing the profitability of the tested party to that of comparable companies rather than comparing particular transactions. In most cases, the tested party should not use intangible property or unique assets that distinguish it from unrelated comparable companies.

The profit split methods allocate operating profits or losses from controlled transactions in proportion to the relative contributions made by each party in creating the combined profits or losses. Relative contributions may be determined by functions performed, risks assumed, resources employed, and costs incurred. The final regulations include two profit split methods. The first is the comparable profit split method. Under this method, transfer prices are derived from the combined operating profit of uncontrolled taxpayers whose transactions and activities are similar to those of the controlled taxpayers in the relevant business activity. Under this method, each uncontrolled party's percentage of the combined operating profit or loss is used to allocate the combined operating profit or loss of the relevant business activity between the related parties.

The second is the residual profit split method. This method involves two steps. First, operating income is allocated to each party in the controlled transactions to provide a market return for their routine contributions to the relevant business activity. Second, any residual profit is divided among the controlled taxpayers based on the relative value of their contributions of any valuable intangible property to the relevant business activity. This method is best suited for analyzing the transfer of highly profitable intangibles.

A method not specified in the regulations (i.e., an "unspecified method") may be used by a taxpayer if it is applied according to the provisions in Section 482. In practice, an unspecified method is used when its results are more reliable than the results achieved by the specified methods.

C. Transfer Pricing Methods for Intangible Property

The methods available in the U.S. to determine arm's length pricing in a controlled transfer of intangible property are the comparable uncontrolled transaction method, the comparable profits method, the profit split method and unspecified methods.

The comparable uncontrolled transaction method is similar to the comparable uncontrolled price method described earlier for tangible property transactions. The rest of the methods listed for intangible property are the same as the methods for tangible property.

D. Transfer Pricing Methods for Services

The U.S. regulations do not specify methods to be applied in the determination of arm's length compensation for the performance of services. In practice, the methods described for transfers of tangible property are used in these instances.

III. Transfer Pricing Guidelines and Regulations

A. OECD Guidelines

The Organization for Economic Cooperation and Development released a set of guidelines in 1995 and 1996 that reflect an international consensus on the application of the arm's length standard. These guidelines reaffirm the arm's length principle and provide guidance for the application of transfer pricing methodology. In most jurisdictions, these guidelines do not have the force of law and have to be incorporated into domestic taxing statutes.

B. United States

Section 482 of the Internal Revenue Code authorizes the IRS to allocate income and deductions between commonly controlled enterprises to place them on a tax parity with independent enterprises dealing at arm's length. Under sections 6662(e) and (h) of the Internal Revenue Code, transfer pricing adjustments that exceed certain objective thresholds are subject to transfer pricing penalties calculated at 20 or 40 percent of the additional taxes resulting from the adjustments. A transfer pricing penalty will not be imposed if both the specified method requirement and the documentation requirement in the transfer pricing penalty regulations are satisfied. The specified method requirement is satisfied if a specified method is selected and the taxpayer reasonably concludes that the method, as applied, provides the most reliable measure of the arm's length result of the taxpayer's controlled transactions.

C. Mexico

Mexico amended its Income Tax Law and Federal Fiscal Code effective January 1, 1997 to provide a more comprehensive statutory basis for enforcing the arm's length standard in cross-border transfer pricing. Special provisions exist for maquiladoras and they are generally updated every year. Generally speaking, the transfer pricing regulations conform to the transfer pricing guidelines of the OECD, of which Mexico is a member.

Mexico's transfer pricing rules cover transfer pricing methods, transfer pricing documentation, transfer pricing penalties, and transfer pricing rulings. Article 64-A of the Mexican Income Tax Law imposes an express obligation upon taxpayers to determine income and deductions from related party transactions by reference to comparable, uncontrolled transactions. The obligation is enforced by an amendment to Article 76 of the Mexican Federal Fiscal Code, which imposes a penalty for understatement of tax, including understatements attributable to transfer pricing adjustments. This penalty can range from 50 percent to 100 percent of the tax deficiency. The percentage depends on several factors, such as how and when the understatement was discovered.

D. Canada

Section 247 of the Income Tax Act of Canada pertaining to transfer pricing was enacted on June 18, 1998, effective for taxation **years** and fiscal periods that begin after 1997. The essential requirement of this section is that taxpayers follow the arm's length standard.

Subsection 247(3) imposes a penalty on transfer pricing reassessments levied by the Canada Customs and Revenue Agency if the amount of the reassessment is greater than the lesser of (a) 10% of the gross revenue of the taxpayer and (b) \$5 million. This subsection also states that a penalty may be avoided if the taxpayer has made reasonable efforts to determine arm's length transfer prices.

Subsection 247(4) pertains to contemporaneous documentation. It states that a taxpayer has not made reasonable efforts to determine and use arm's length transfer prices unless the taxpayer makes or obtains, on or before the filing date of its tax return for the year, records or documents that provide a description that meets the requirements for documentation.

The penalty provision contained in the Canadian legislation is applied on the reassessed amount rather than on the additional tax owing as in other countries, and any interest owing on the penalty would not be tax deductible.

E. Other Latin American Countries

Argentina enacted major transfer pricing legislation in September 1998, through changes to Article 15 of Argentina's Income Tax Laws. The new transfer pricing legislation requires taxpayers to use the most appropriate measure, determined in light of the facts and circumstances. This rule is analogous to the U.S. "best method" requirement.

The Brazilian transfer pricing rules, introduced in May 1997, implemented legislation that imposed **minimum** profit margins between 15 and 30% based on the transfer pricing method applied and whether the transaction flow is inbound or outbound. The regulations specify average uncontrolled prices as benchmarks. Brazilian transfer pricing rules do not apply the arm's length principles as they are described in the OECD model.

Other Latin American Countries have not adopted comprehensive transfer pricing legislation. Some countries, like Colombia and Chile have reported incorporating the arm's length principle based on the OECD model when addressing intercompany transactions.

IV. Business Perspective on Transfer Pricing Regulations

Transfer pricing is one of the most important considerations facing **MNCs** today. The costs and potential disruption to business associated with transfer pricing issues can be significant. Mechanisms available to U.S. taxpayers to reduce exposure to transfer pricing problems include: contemporaneous documentation, advance pricing agreements, cost sharing arrangements and the mutual agreement procedure. These four mechanisms are briefly explained below.

Contemporaneous documentation is a transfer pricing study that satisfies the requirements in the U.S. regulations and that can protect taxpayers from penalties. The contemporaneous documentation requirement is satisfied if certain “principal documents” and supporting “background documents” are produced to the IRS within 30 days of being requested during an examination.

An advanced pricing agreement is an arrangement by which the tax authority and the taxpayer agree to transfer pricing methodology and its proper application to the taxpayer’s facts and circumstances in intercompany transactions over a certain period of time. In an **APA**, the parties reach agreements through negotiation. **APAs** can be unilateral, bilateral or multilateral. In unilateral **APAs** successful negotiations result in a binding agreement of the facts, a transfer pricing methodology, and a range of results. For bilateral and multilateral **APAs**, successful negotiations result in an agreement on the U.S. competent authority’s initial negotiating position with respect to the foreign competent authority.

Cost-sharing arrangements are created when two affiliated entities in separate countries agree to share the costs of developing a new product. Under such an agreement, the U.S. parent may own the rights to manufacture and market the new product in the United States, while the subsidiary in another country may own the rights to manufacture and market the new product outside the U.S. The advantage of a cost-sharing arrangement for taxpayers is that the foreign subsidiary’s ownership of the foreign rights to the intangible negates the need to have that subsidiary pay a royalty to its U.S. parent. A bona fide cost-sharing arrangement must allocate research and development costs in proportion to the profits earned by each controlled party from the intangible, and each controlled party must bear a portion of the costs incurred at each stage of the development of both successful and unsuccessful intangibles.

The mutual agreement procedure provides an administrative mechanism by which the competent authority of one country can negotiate with the competent authority of another country to determine the appropriate application of tax treaty rules when transfer pricing disputes arise. The purpose of this process is to eliminate double taxation.

These four mechanisms can be costly and generally require consultation at the government level.

V. Conclusion

In response to the growth in international trade and the increased scrutiny of intercompany transactions by the tax authorities, there is an emerging need for the continuous development of transfer pricing policies and regulations that allow **MNCs** to meet their responsibility for compliance without significant burden on their operation.