

Fair Game

Why you need a transfer pricing policy now.

BY MOSES MAN

WITH INCREASING GLOBALIZATION, even small businesses and startups can have a worldwide footprint. This is especially true in technology, where intellectual property is the heart of the business and can easily — and unknowingly — be exchanged among the company's related entities in foreign jurisdictions.

As governments worldwide work to increase their tax bases and, more important, maximize their income from tax revenues, the allocation of profits between different tax jurisdictions has become a key focus. This brings us to an area of taxation known as transfer pricing, the amount paid between related parties for the intercompany exchange of services, goods and intangibles.

While establishing a pricing strategy is critical to your company's success, the policies and strategies behind your *intercompany pricing* are equally critical, not only from a profitability perspective but also from a tax perspective. For instance, operating in other countries can reduce costs by using less expensive labor. Working out exactly what to pay for those services, however, is no small matter. You can't just pluck a number out of thin air, no matter how great it looks for your income statement. That's because the rules and regulations guiding the pricing of goods, services and intangible property between related entities must be at "arm's length," that is, the price paid/charged for a related party transaction is consistent with what would have been agreed upon by unrelated parties under the same circumstances.

Let's say you have a company based in Seattle. You create a subsidiary in India, hoping to capitalize upon that country's

abundant lower-cost talent in your field. Your United States headquarters will compensate the Indian subsidiary for the work performed through a transfer price. The Indian subsidiary will pay taxes on this compensation, while U.S. taxable income is reduced by the amount of compensation. Thus, the level of compensation will be subject

to both U.S. and Indian transfer pricing regulations to ensure that the United States is not losing tax revenue because you priced the provision of the services above what a third party would have paid for such services, and to ensure that India is not losing tax revenue

because you priced those services lower than what a third party would have charged. Either scenario could lead a tax authority to issue an adjustment to income and, in some cases, levy penalty fees.

While the media have focused on transfer pricing controversy for large companies such as Google, Amazon, Starbucks and Microsoft, small and midsize firms and startups are coming under increased scrutiny as well. Many nations view less mature companies as "low-hanging fruit" — that is, opportunities to increase their tax revenue — because these companies either lack adequate transfer pricing policies or tend to price their intercompany transactions improperly.

Among the various factors in determining a proper transfer pricing policy, the top three that a small or midsize firm should keep in mind are:

1. What types of intercompany transactions take place in your company in any given year?
2. What support do I have that these transactions are at arm's length (such as transfer pricing studies, intercompany agreements, third-party pricing, etc.)?

Getting the right transfer pricing policies in place as soon as possible — ideally in conjunction with the growth of your company — gives you the freedom to operate internationally while mitigating tax risk.

3. What realistic alternatives to an intercompany transaction were available? For example, instead of licensing the software from the parent company, what would the costs be for the subsidiary to develop the software itself?

Getting the right transfer pricing policies in place as soon as possible — ideally in conjunction with the growth of your company — gives you the freedom to operate internationally while mitigating tax risk.

MOSES MAN, CPA, is a manager in Clark Nuber's Tax Services Group, specializing in international tax. Reach him at mman@clarknuber.com.

