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Lost in Translation: Where Did My Cash Flow Go?

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Strategic transfer pricing planning can be an intriguing cash flow improvement opportunity for struggling multinational companies.

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In today's economic environment, governments around the globe are concerned with shrinking corporate income tax receipts. Multinational companies have again moved into the spotlight over charges of not paying their fair share of taxes. During a July 2010 Ways and Means' Committee hearing, Congress and the Internal Revenue Service (IRS) raised concerns over multinational companies shifting profits offshore through transfer pricing. In fact, every IRS tax audit now includes a review of transfer pricing practices.

While transfer pricing is considered the most contentious tax issue facing multinationals, intercompany pricing may be overlooked when developing solutions for cash-strapped companies. This is understandable in that companies fighting for survival are more interested in addressing immediate cash flow needs. Transfer pricing is regularly considered "just a tax issue," but company management may miss a valuable cash flow improvement opportunity through a thoughtful approach to intercompany pricing.

Simply stated, transfer pricing regulations govern the pricing of goods, services, royalties and other transactions between related companies. As an example, if Ford-U.S. is selling vehicles to Ford-Canada at too high a price, the Canadian Revenue Authority will conclude that Ford-Canada is paying too little tax. Conversely, if Ford-U.S. is charging too low a price to Ford-Canada, the IRS will challenge Ford-U.S for not paying enough taxes in the U.S. Virtually every multinational company has transactions that are subject to intercompany pricing rules where local country taxable income can be increased during an audit. Both U.S. and foreign owned companies can be audited for transfer pricing by the IRS.

Why would cash strapped companies care about transfer pricing? Intercompany pricing drives where cash ends up within a multinational company. Consider a company that makes all the right operational moves—rationalizing manufacturing capacity, improving cash collections from customers and strengthening product development strategies. Unfortunately, management may be surprised to find profits "trapped" in certain tax jurisdictions where cash cannot be readily repatriated to service debt elsewhere.

A typical intercompany pricing cash flow problem occurs where companies rely on an outdated policy for intercompany transactions. Reasons vary, but many companies have "always done it this way." For example, if a U.S. debt-laden company exports a successful product line on a one-size-fits-all cost plus basis to a related distribution company, the distributor could earn the majority of profits. Beyond the cash repatriation and debt service issues, the company will overpay tax in the country where the distributor operates and face audit risks at home.

Is this a tax avoidance scheme? Absolutely not. Since many cash-strapped companies do not address intercompany pricing on a regular basis, a strategic review of transfer pricing helps multinational companies manage transfer pricing audit risks while improving cash flow. *A proper transfer pricing strategy is a proactive approach to comply with tax laws in the U.S. and internationally.*

Transfer pricing audits can be draconian in nature. Many tax authorities can apply nondeductible penalties in addition to increasing taxable income. In the U.S., these nondeductible transfer pricing penalties can range from 20 to 40 percent of the additional tax payable if the company does not have transfer pricing documentation. Transfer pricing adjustments can also result in double taxation for multinational companies.

As an example for a company currently paying tax, if an IRS agent issues a taxable income adjustment of $10 million for improper transfer pricing, the company would owe income tax of $3.5 million, plus late interest, plus a 20 percent nondeductible penalty of $700,000. The company would also owe late payment of state and local taxes. This nondeductible penalty increases to 40 percent, if the taxable income adjustment is greater than $20 million. Even if a company is not currently paying tax, the IRS can reduce tax net operating losses, again putting the company at a risk of double taxation.

In addition, transfer pricing compliance is driven by an assessment of facts-and-circumstances, so company management can expect to spend substantial time with tax authorities during audits.

Why would transfer pricing be important now? Over 60 countries (and growing) have formal intercompany pricing regulations in place. The IRS announced a new initiative to strengthen its transfer pricing enforcement regime by doubling its specialist transfer pricing team as of October 1, 2010. In addition, the IRS is now required to request transfer pricing documentation reports as a part of every tax audit.

Given the IRS' focus on multinationals shifting profits offshore, companies can expect to be asked if artificial transfer pricing is the reason (1) why tax is not being paid locally and (2) why overseas companies are earning too much profits. Other tax authorities ask similar questions when auditing transfer pricing. Multinational companies need to be able to explain and support their intercompany pricing practices through transfer pricing documentation reports.
Does the IRS audit small- and mid-sized companies for transfer pricing? Yes, the IRS and other tax authorities also audit transfer pricing for small- and mid-sized international companies. Tax authorities normally adopt a pragmatic approach when selecting audit targets, but small- and mid-sized companies in the U.S. may face additional scrutiny with so many new economist hires training on the job.

Due to the large dollar amounts involved, transfer pricing disputes can drag on for over 10 years, especially in cases where a company faces a double tax situation.

What if ownership plans to sell the company soon? Beyond the cash flow improvements from transfer pricing planning, a buy-side due diligence routinely reviews tax issues such as transfer pricing. Since tax authorities can adopt diametrically opposed approaches as to what is the "correct" transfer price, a buy-side due diligence may actually uncover more than one surprise transfer pricing tax liability. Private equity companies may need to reduce their selling price due to these liabilities or assume the risk of a future transfer pricing adjustment.

For cash-strapped companies, transfer pricing—if ever mentioned—has long been assumed to be a tax-only issue. Intercompany pricing should be an important consideration for multinational companies in the restructuring process. Managing global effective tax rates, while certainly important, should not be the only focus when reviewing transfer pricing among related companies. Cash is king, and a strategic approach to intercompany pricing can prevent cash flow from becoming lost in translation.

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Productive Pricing works with multinational companies of all sizes, accounting firms, turnaround management consultants and private equity firms and to develop practical strategies for addressing complicated transfer pricing issues.

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