



Insights: Transfer Pricing

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Navigating transfer pricing amidst economic headwinds

The economy continues to make the headlines as we near the end of 2022 due to a confluence of factors, which may have an impact on transfer pricing policies within multinational groups. Economic conditions are integral to transfer pricing analyses from a comparability perspective;¹ accordingly, it is important to monitor macroeconomic trends. As always, it is advisable to proactively address potential transfer pricing issues. This involves keeping abreast of internal business changes and in times of economic turbulence, there is the added issue of predicting movements in benchmarks.

We conducted a simulation to derive indicative interquartile ranges for certain US comparable company sets results for 2022 based on quarterly financial filings. We are advising clients on some of the issues and trends that we observed. In this *Insights* we provide a summary of some of the issues to look out for and the transfer pricing implications.

Inflation

The producer price index (PPI) is a good gauge of how prices are increasing throughout the supply chain, from raw material and component prices to transportation and labor costs. For the 12 months ended September 2022 the PPI is 8.5 percent.² This is an inflationary environment that has not been experienced since the 1970s and is new to many of us. The impact of inflation on firm profitability is dependent on the ability to pass cost increases on to customers and consumers. This in turn is a function of the level of competition in the industry as well as contractual arrangements that may lock in prices for a set period of time.

Within a vertically integrated multinational group, we observe that inflation is showing up in the financial statements of routine entities, often contract manufacturers and other service providers, as well as distributors. This poses a variety of transfer pricing issues to think through, including whether cost-plus service entities are unjustly rewarded for higher input prices and how to true-up import prices to hit distributor benchmarks before year-end. Transactions tested under the comparable uncontrolled price (CUP) also need to be recalibrated if the benchmark prices have changed during 2022.

¹ See US Treasury Regulations §1.482-1(d)(iv), Allocation of income and deductions among taxpayers; Cornell Law School, Legal Information Institute, <https://www.law.cornell.edu/cfr/text/26/1.482-1>; see also 2022 OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations Chapter 1 Section D.1.4, <https://www.oecd.org/tax/transfer-pricing/oecd-transfer-pricing-guidelines-for-multinational-enterprises-and-tax-administrations-20769717.htm>.

² See US Bureau of Labor Statistics, "Producer Price Index News Release summary," October 12, 2022, <https://www.bls.gov/news.release/ppi.nr0.htm>

The impact of inflation on comparable companies is mixed across different firms included in our simulation. Many companies discuss inflation as a material business risk in their recent SEC filings. In some instances, companies are able to pass cost increases through to their clients whereas other companies are not able to fully offset higher costs. Another factor in observed profitability is cost savings at the general and administrative (G&A) level where, for example, travel and entertainment budgets remain tightly controlled. We also observed in our simulation that the materiality of depreciation and other fixed costs that are less sensitive to current inflation and the selection of the profit level indicator (PLI), also have an effect on the benchmarked profitability.

Exchange rates and interest rates

The US dollar has strengthened considerably against other currencies during 2022. Intercompany agreements stipulate the functional currency of the arrangement and thereby assign exchange rate risk to one of the parties. A check should be performed to determine that foreign exchange gains or losses are being recognized in the appropriate legal entities. Certain US comparable companies with substantial international operations in our simulation are reporting that the exchange rate is negatively impacting their profitability, which may warrant a comparability adjustment if the tested party does not bear such risk.

Central banks around the world have been raising interest rates as it became apparent that inflation was not transitory.³ This has increased the cost of capital for firms which should be reflected in new intercompany loans or those with floating interest rates. Additionally, any income approach valuation analysis requires additional diligence into each input and assumption in the discount rate to accurately determine the appropriate cost of capital. An increase in the risk-free rate (holding all other assumptions equal) increases the resulting weighted average cost of capital, which will have the effect of decreasing the value of the asset or equity subject to valuation. Lastly, increased interest rates are having a more material impact on working capital-adjusted PLIs, which we are able to simulate to update year-end target profitability.

Inventory and supply chain disruptions

Companies with physical supply chains are acutely aware of inventory issues. Just-in-time and just-in-sequence supply chain models were fine-tuned over the years based on predictable supply and transportation. The pandemic and its aftermath have posed significant challenges for these models. The war in Ukraine has exacerbated these issues. There is a shortage of microchips and other materials, some factories close for prolonged periods due to continuing COVID-19 outbreaks, and shipping costs and times have sharply increased. As a result, companies have furloughed facilities to manage capacity, built up safety stock, added duplicate vendors or service providers, and paid more for freight. The sanctions on Russia have led to companies withdrawing from that market, sometimes voluntarily.⁴ These all add costs to the group and from a transfer pricing perspective it is necessary to determine which entities should bear those costs and whether the appropriate entities are indeed bearing the costs.

³ Enda Curran, "World's Central Banks Got It Wrong, and Economies Pay the Price," Bloomberg, June 15, 2022, <https://www.bloomberg.com/news/articles/2022-06-15/world-s-central-banks-got-it-wrong-and-economies-pay-the-price?leadSource=uverify%20wall>

⁴ "Companies Are Getting Out of Russia, Sometimes at a Cost," The New York Times, October 14, 2022, <https://www.nytimes.com/article/russia-invasion-companies.html>

Supply chain resiliency

Several of our clients have undertaken a substantial reimagining of their supply chains in an effort to decrease exposure to factors outside of their control, such as establishing manufacturing and distribution facilities closer to major end markets and dynamic distribution models. For transfer pricing purposes, a business restructuring analysis is required in cases when capacity is removed from existing operations or relocated entirely. Any exit charges should be factored into the overall cost of the restructuring for business purposes.

Dynamic distribution refers to an approach that companies are adopting whereby available finished goods (or component parts) inventory is moved to supply higher value markets in the event that there is an overall shortage. This increases the flow of goods across the supply chain and often creates distributor-to-distributor (or manufacturer-to-manufacturer) transactions that might not have existed before and need to be priced. A complication is added when goods pass from the territory of one principal company to the territory of another principal company, which could happen if the group has a cost sharing structure in place. A new survey of intercompany transaction flows may be required to identify all instances of one-time transactions so that the transactions can be priced and documented appropriately.

Talent

While many economic metrics point to a recession, the labor market remains strong with full employment and record job vacancies. Companies have reacted in various ways to retain or attract talent. Many management jobs are now hybrid or remote and this has led to employees moving overseas or out of state or becoming digital nomads, while new hires can be hired remotely. Many taxpayers are adopting a strategy of employing their remote and mobile employees via a subsidiary that functions as a global employment company (GEC) which requires transfer pricing benchmarking.

Other companies have faced challenges finding available skilled labor to expand operations and have established entities in entirely new jurisdictions to service business needs. Examples include call centers and back-office support functions. A transfer pricing benchmark is required as part of the planning for these new entities.

Final thoughts

Economic conditions is a comparability factor in the transfer pricing rules. In times of acute economic instability, such as the period that we are going through, companies need to pay close attention to how macroeconomic factors impact internal operations and financial results, as well as external benchmarks such as CUPs and the profitability of comparable companies. The lag in the availability of benchmark data makes aligning transfer pricing policies and results with market data more complex. For those taxpayers able to proactively identify issues (for example, which entities are bearing foreign exchange losses and unbudgeted expenses; carrying safety stock or slow-moving inventory; subject to higher costs of capital; or may require pricing associated with new transaction flows or a business restructuring), the year-end processes and documentation will be easier.

About CRA's Transfer Pricing Practice

Our consultants help clients navigate every phase of implementing and supporting international tax structures including: intangible property (IP) and acquisition planning, documentation, and audit defense. We also provide litigation support and expert testimony services in tax and transfer pricing disputes.

For more information about this edition of *Insights: Transfer Pricing*, and our services, contact:

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