# Manufacturing & Distribution: Take Care with Transfer Pricing

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Before you sell equipment or patent rights to a company affiliate, think twice about the price. The IRS recently announced the launch of their “Inbound Distributor Campaign,” which is one of thirteen issue-based examinations and compliance campaigns. The Inbound Distributor Campaign targets treaty and transfer pricing operations through the development of a comprehensive training strategy to aid revenue agents.

Manufacturers and distributors who don’t follow the rules can be taxed twice on transactions and face hefty penalties to boot. If your company has multiple entities that buy and sell from one another, now is the time to review your transfer pricing policies.

**What is transfer pricing?**

“Transfer pricing” refers to the price that related parties, such as divisions of a company, charge one another for goods or services. These include tangible goods, services, intangible property, interest on loans and other financial transactions.

Transfer pricing piques the interest of tax authorities because it affects the amount of taxable profits for each division of a company. Because taxes vary from country to country, a company could theoretically slash its tax burden by transferring income to another division in a lower tax bracket. A U.S. dress distributor, for example, could buy dresses from its plant in Malaysia, where taxes are lower, at artificially high prices to reduce its taxable income in the United States. Transfer pricing laws prohibit these transactions from occurring to ensure each country gets its fair share of tax revenue.

Most countries have the authority to adjust the price of transactions between companies in their jurisdictions and foreign entities. This makes transfer pricing a hot issue for multinational manufacturers and distributors. Even manufacturers and distributors whose operations are within U.S. borders need to handle transfer pricing carefully, though, because the United States can adjust prices between domestic related parties.

**Is the transaction at “arm’s length”?**

Countries generally require transactions between related parties to meet an “arm’s-length” standard, which means the price is comparable to what it would have been if the parties weren’t related. When comparing pricing for a transaction to similar transactions between unrelated parties, consider all applicable conditions, including the geographic market, related warranties and other terms of sale. Because comparable transactions can be difficult to find, particularly for intellectual property or other intangible goods, the resulting arm’s-length standard often includes a range of prices rather than a specific price.

A growing number of countries, including the United States, China, India and Italy, require companies to prepare transfer pricing studies that show the basis behind their pricing. After manufacturers and distributors prepare their studies, they need to stick to them — tax authorities will penalize companies whose actual pricing for transactions differs substantially from the pricing included in their studies.

**Is an audit in your future?**

Even if your company follows all transfer pricing rules, you may still be subject to an audit of your transfer pricing practices. Common audit triggers include low gross margins compared to industry standard, large transactions; royalties or payments for intangible goods; operating losses, particularly multiyear losses; large year-to-year shifts in the level of profits or losses; transactions with related parties in low-tax countries; and a low effective tax rate compared with gross revenue.

The key to surviving an audit is having the appropriate transfer pricing documentation in place before the authorities come knocking. A transfer pricing study is one of the first things the IRS requests during an audit and, while it takes several months to complete one correctly, the IRS typically wants it in 30 days. Additionally, the law specifies contemporaneous completion of transfer pricing studies completed with annual filing of form 5472.

**The price you would pay**

If a government decides that the price you charged or paid to a related party was inappropriate, it will adjust the price and tax you on the difference — meaning you pay tax on income that your related party already paid tax on. Manufacturers and distributors that don't have required transfer pricing studies in place also are subject to penalties if certain thresholds are met.

A penalty will apply if the underpayment of tax attributable to all valuation misstatements exceeds $5,000 for individuals, S corporations, and personal holding companies, or $10,000 for corporations. A penalty may be applied on either the transactions or the net-adjustment.

A 20% penalty is applied on transactions in which the correct price is overstated on the return by 200% or more, or understated by 50% or less. Transactional penalties are increased to 40% when the correct price is overstated on the return by 400% or more, or understated by 25% or less.

A net-adjustment penalty of 20% is applied when the net of adjustments made exceeds the lesser of $5 million or 10% of the taxpayer's gross receipts for the tax year in question. This penalty increases to 40% when the net of adjustments made exceeds the lesser of $20 million or 20% or the taxpayer's gross receipts for the tax year in question.

**Play by the rules**

If your company has multiple entities that buy and sell from one another, review your transfer pricing policies with a VonLehman tax professional to ensure they're in compliance.