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Introduction

The story of St. Louis-based Acme Aerospace Corporation offers multiple examples of intercompany pricing issues that could exist within today’s increasingly complex multinational corporation. The following case study and solution guide looks at these transfer pricing-related issues and offers potential solutions, addressing the best course of action for Acme. While all intercompany pricing arrangements are unique, a look at Acme’s history and fact pattern can offer insights that could be applied to other companies in similar situations.

Definitions

<table>
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<tr>
<th>Abbreviation</th>
<th>Description</th>
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<tbody>
<tr>
<td>AABL</td>
<td>Acme Aerospace do Brasil Limitada</td>
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<tr>
<td>AAC US</td>
<td>U.S. parent</td>
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<tr>
<td>AACC</td>
<td>Acme Aerospace Cayman Islands Corp.</td>
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<td>AACL</td>
<td>Acme Aerospace China Ltd.</td>
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<td>AAF</td>
<td>Acme Aerospace France SARL</td>
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<td>Acme</td>
<td>The worldwide group</td>
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<tr>
<td>IDC</td>
<td>Intangible development cost</td>
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<td>IPR</td>
<td>Intangible property rights</td>
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<td>McHugh</td>
<td>McHugh worldwide group</td>
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<tr>
<td>McHugh US</td>
<td>U.S. parent of McHugh segment</td>
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<tr>
<td>PCT</td>
<td>Platform contribution transaction</td>
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<tr>
<td>RAB</td>
<td>Reasonably anticipated benefits, i.e., buy-in</td>
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<td>Royal</td>
<td>Royal worldwide group</td>
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Acme Aerospace Case Study

Charles A. Dillon was born in Denver, Colorado, and raised in Little Rock, Arkansas. He was a graduate of Princeton University and Massachusetts Institute of Technology, where he earned undergraduate and graduate degrees in aerospace engineering. After graduate school, he served as a pilot in the Army Air Service Reserve during World War I. In 1928, he founded his first aerospace company, Dillon & Associates, in Milwaukee, Wisconsin. The Great Depression led to the demise of his company, and he went to work for two aerospace companies: Glenn L. Martin and Huff Daland Airplane Company.

Acme prospered during World War II, supplying its Fetzer valves to several prominent aerospace companies including McDonnell Aircraft (later McDonnell Douglas), Hughes Aircraft Company, Northrop Aircraft Company (later Northrop Grumman), Boeing Company and Lockheed. In the jet age, Acme developed multiple generations and variations of its Fetzer valves and moved into the production of several other critical aerospace components.

From the 1960s through the 1990s, Acme witnessed massive growth and established manufacturing locations in St. Louis, Missouri; Wichita, Kansas; Long Beach, California; Huntington Beach, California; Salt Lake City, Utah; Charleston, South Carolina; and Tempe, Arizona. Charles Dillon’s son, John, led Acme as chairman and CEO from the time of his father’s death in 1981 until 1991, when he hired Larry Morgan to serve as CEO. John Dillon continues to serve as Acme’s chairman, while Morgan runs Acme’s day-to-day operations. Acme went public in 1991, with shares traded on the New York Stock Exchange under the ticker symbol AAC.

Global Growth

In the mid 2000s, Dillon and Morgan determined Acme needed to expand internationally in order to grow its customer base and capitalize on lower labor costs.

The first step in Acme’s international expansion came in 2006, when Acme established Acme Aerospace China Ltd. (AAC US), a Chinese subsidiary of Acme Aerospace China Ltd. (AAC US), a wholly foreign-owned enterprise (WFOE) operating a manufacturing plant in Suzhou, China. Production of two of Acme’s Fetzer valves was moved to AAC US’s Suzhou plant in early 2007. AAC US gained expertise on how to manufacture the Fetzer valves from 25 AAC US personnel sent to China throughout 2006. AAC US also transferred to AAC US’s Chinese subsidiary, Acme Aerospace China Ltd. (AACL), the production equipment previously used at its former manufacturing plant in Long Beach, California. AACL sells the Fetzer valves it manufactures to various Acme foreign affiliates, notably AAC US, and to AACL’s own customers in China. Given China’s growing aerospace industry, AAC US also purchases other variations of Fetzer valves from AAC US’ St. Louis plant for resale to third-party aerospace companies in China.

After AAC US’ sales personnel won a large contract with Airbus (EADS) in 2007, Acme established a French subsidiary – Acme Aerospace France SARL (AAF) – in Toulouse, France. AAF purchases Fetzer valves from AAC US’ St. Louis plant and from AACL’s Suzhou plant and resells them to Airbus for use in production of its commercial airplanes. For the fiscal year ended December 31, 2011, AAF earned a pre-tax operating margin of 25.4 percent on its purchase and resale of Fetzer valves purchased from AAC US and AACL.

In 2007, Acme acquired McHugh Services Company, based in Philadelphia, Pennsylvania. McHugh has contracts with airlines around the world to service Fetzer valves. Fetzer valves require mandatory servicing.

The process of servicing and fixing Fetzer valves is complex, requiring technicians to undergo significant training and use unique tools developed by McHugh US.
Acme Aerospace Case Study

for every 250,000 miles flown. The process of servicing and fixing Fetzer valves is complex, requiring technicians to undergo significant training and use unique tools and processes developed by McHugh US. McHugh US has subsidiaries in the United Kingdom, France, Spain, Belgium, Ireland, Hungary, the Netherlands, Switzerland, Germany, South Africa, Canada, Brazil, Argentina, Mexico, Japan, China and Australia. Post-acquisition, McHugh US continues to serve as the McHugh division’s headquarters. While all historical service know-how, processes and tools were developed at McHugh US’ Philadelphia headquarters, McHugh US has built a service database on how to service Fetzer valves; all of the McHugh subsidiaries now contribute their experience to the database. Fetzer valve servicing is highly profitable, and the McHugh division accounts for 35 percent of Acme’s gross profits but only 15 percent of its revenues.

In 2008, AAC US purchased the Fetzer valve software division from defense giant Royal Corporation, a company headquartered in Boston, Massachusetts. Royal’s software operates the Fetzer valves. A year later, AAC’s in-house tax department established a Cayman Islands corporation (AACC) to engage in a research and development cost-sharing arrangement with AAC US. Under the terms of the cost-sharing arrangement, AAC US owns intangible property rights (IPR) for the North American market and AACC owns the IPR for the rest of the world. Acme’s tax department determined AACC did not need to make a buy-in payment (or platform contribution transaction), given that a third-party valuation firm’s valuation report covering the purchase price allocation did not attribute any value to the pre-existing intangible property.

In late 2009, Acme US established Acme Aerospace do Brasil Limitada (AABL, a wholly owned subsidiary in Brazil) to sell Fetzer valves to Embraer. AAC US sells the Fetzer valves directly to Embraer, while AABL provides customer service to Embraer. AABL has not recorded any profits to date.

AAC US also recently established subsidiaries in Zurich, Switzerland, and Singapore, which will serve as the European and Asian headquarters and are responsible for overseeing the subsidiaries and growing revenues in their respective regions. Several senior-level executives were transferred from AAC US to the Swiss and Singaporean entities.

Acme International Issues

Acme Tax Director Drew Hardwood attended a recent meeting of Acme’s financial statement audit committee, where he learned from Acme’s financial statement auditors that Acme’s transfer pricing-related issues are no longer immaterial to the group’s consolidated financial statements. The auditors plan to examine transfer pricing-related issues as part of their Financial Accounting Standards Board’s Interpretation No. 48 (FIN 48), Accounting for Uncertainty in Income Taxes, analysis during their next audit. This announcement has Mr. Hardwood worried, because Acme has not undertaken any formal transfer pricing studies and Acme’s affiliates in the U.S., Brazil, China and France have received notice of impending tax audits.

Group 1 - Tax Authorities
1. Identify all related-party transaction flows, e.g., services, transfers of tangible property, transfers of intangible property, etc.
2. What questions would you ask during a functional analysis, i.e., fact-finding, meeting?
3. What existing intercompany transactions would you challenge as they do not appear to conform to the arm’s-length standard?
   a. From what side, i.e., jurisdiction?
   b. Why?
4. What additional intercompany transactions would you impose?
   a. From what side, i.e., jurisdiction?
   b. Why?

Group 2 - Tax Advisors
1. Identify all related-party transaction flows, e.g., services, transfers of tangible property, transfers of intangible property, etc.
2. What questions would you ask during a functional analysis meeting?
3. What transfer pricing-related opportunities would you bring up to Mr. Hardwood from a planning and/or operational standpoint?
4. What transfer pricing-related threats would you bring up to Mr. Hardwood from an audit and/or operational standpoint?
5. How would you approach the topic of transfer pricing documentation with Mr. Hardwood—both for tax purposes and for book, e.g., FIN 48, purposes?
I. Acme Aerospace China Ltd. (AACL)

A. Intangible property (know-how) transfer from AAC US to AACL

1. Summary

“AACL gained expertise on how to manufacture the Fetzer valves from 25 AAC US personnel sent to China throughout 2006.”

AAC US has transferred intangible property, i.e., know-how and technology, to AACL; therefore, AAC US, through transfer pricing mechanisms, should receive arm’s-length remuneration for this transaction.

There are several possible approaches to address this intercompany transaction:

Option 1 – Contract manufacturing

AACL could be characterized as a contract manufacturer and AAC US could be characterized as an entrepreneur/principal. Under this scenario, AACL would produce finished valves on behalf of AAC US and AAC US would sell to third-party and related-party customers. AACL would earn a routine return, e.g., fully loaded cost plus mark-up, consistent with third-party manufacturing services providers. For AAC US’ product sales to AACL and AAF, AACL and AAF would be characterized as resellers, and the transfer prices could be set so AACL and AAF would earn routine returns, e.g., operating margins, consistent with third-party resellers. Given that AACL is operating as a contract manufacturer on behalf of AAC US, no royalty is due to AAC US.

Option 2

AACL could be characterized as a full-fledged licensed manufacturer, and AAC US could be characterized a licensor and distributor. Under this scenario, AACL would pay AAC US a royalty (as a percentage of net sales) on AACL’s sales to third parties and related parties. For AACL’s product sales to AAC US and AAF, AAC US and AAF would be characterized as resellers, and the transfer prices could be set so AAC US and AAF would earn routine returns, e.g., operating margins, consistent with that of third-party resellers.
Option 3

Option 3, the more common approach, is a blend of Options 1 and 2.

For products manufactured by AACL and sold to AAC US, AACL could be characterized as a contract manufacturing services provider with AAC US characterized as a principal. AACL could earn a return, e.g., fully loaded cost plus mark-up, consistent with a manufacturing services provider, and a royalty payment to AAC US would not be required as contract manufacturers are often granted royalty-free license to produce goods on behalf of the principal.

For products manufactured by AACL and sold to third-party customers in China or to AAF, AACL could be characterized as a full-fledged licensed manufacturer. AACL could pay AAC US a royalty, as a percentage of sales to third parties and to AAF, to exploit transferred know-how. AAF could be characterized as a reseller and could earn a routine return, e.g., operating margin, consistent with third-party resellers. A derivative of Option 3 may have AAC US selling AACL-manufactured valves to AAF. In this case, with respect to AACL-manufactured valves destined for resale by AAF, AACL would act as a contract manufacturer, AAC US would act as a principal and AAF would act as a reseller.

2. Functional analysis questions

How has AACL compensated AAC US in the past for the transferred know-how used by AACL? Has a royalty or lump sum fee been paid? How were these amounts determined?

What do AAC US and AACL do to update and maintain the know-how for the valve models manufactured by AACL?

- If AAC US is solely responsible for updating the above-mentioned know-how, it would be appropriate for AACL to pay AAC US a royalty.

- If AACL is solely responsible for updating the above-mentioned know-how, ownership of the know-how would migrate from AAC US to AACL over time. The royalty owed by AACL to AAC US would decay based on the useful life of the know-how and the magnitude of AACL’s development activities.

3. Additional considerations

Outbound royalty payments from China must be approved by a Chinese regulatory authority. A royalty agreement (and possibly a transfer pricing study) would need to be submitted to show support.

The outbound royalty may be subject to withholding and/or business taxes. There should be a review of local tax law and tax treaties.

Intercompany agreements should be drafted to formalize intercompany arrangements. These may include a contract manufacturing services agreement, a development services agreement, a know-how license agreement and supply/distribution agreements.

4. Transactions to be imposed

The IRS could impose a royalty to be paid by AACL to AAC US if AACL is characterized as a full-fledged licensed manufacturer.

If AACL is operating at a loss, the Chinese tax authority could impose a contract manufacturing arrangement where AACL would earn a routine return, e.g., cost plus a mark-up.
B. Production equipment transfer from AAC US to AACL

1. Summary

“AAC US also transferred to AACL the production equipment previously used at its former manufacturing plant in Long Beach, California.”

Transfers of production equipment are typically charged out at cost or net book value. However, if the production equipment has been fully depreciated, the IRS could challenge a transfer at net book value.

2. Functional analysis questions

How were these transactions recorded?

Does AAC US still own the assets, or have they been transferred to the books of AACL?

What values were assigned to these transactions, and how were these values determined?

Has AACL made actual payments for the equipment?

3. Transactions to be imposed

The IRS could impose an incremental income adjustment to AAC US to account for the transfer of equipment by AAC US to AACL.

C. Sale of valves from AACL to AAC US

1. Summary

“AACL sells the Fetzer valves it manufactures to AAC US …”

As discussed in Section I.A.1., there are several possible approaches to address this intercompany transaction:

Option 1

AACL could be characterized as a contract manufacturer, and AAC US could be characterized as an entrepreneur/principal. Under this scenario, AACL would produce finished valves on behalf of AAC US, and AAC US would make sales to third-party and related-party customers. AACL would earn a routine return, e.g., fully loaded cost plus mark-up, consistent with that of third-party manufacturing services providers.
For AAC US’ product sales to AACL and AAF, AACL and AAF would be characterized as resellers, and the transfer prices could be set so that AACL and AAF would earn routine returns, e.g., operating margins, consistent with that of third-party resellers.

Option 2
AACL could be characterized as a full-fledged licensed manufacturer, and AAC US could be characterized a licensor and distributor. Under that scenario, AACL would pay AAC US a royalty, as a percentage of net sales, on AACL’s sales to third parties and related parties. For AACL’s product sales to AAC US and AAF, AAC US and AAF would be characterized as resellers, and the transfer prices could be set so that AAC US and AAF would earn routine returns, e.g., operating margins, consistent with third-party resellers.

Option 3
Option 3, the more common approach, is a blend of Options 1 and 2.

For products manufactured by AACL and sold to AAC US, AACL could be characterized as a contract manufacturing services provider, with AAC US characterized as a principal. AACL could earn a return, e.g., cost plus mark-up, consistent with that of a manufacturing services provider, and a royalty payment to AAC US would not be required.

For products manufactured by AACL and sold to third-party customers in China or to AAF, AACL could be characterized as a full-fledged licensed manufacturer. AACL could pay AAC US a royalty, as a percentage of sales to third parties and to AAF, to exploit the transferred know-how. AAF could be characterized as a reseller and could earn a routine return, e.g., operating margin, consistent with that of third-party resellers. A derivative of Option 3 may have AAC US selling AACL-manufactured valves to AAF. If this is the case, then with respect to AACL-manufactured valves destined for resale by AAF, AACL would act as a contract manufacturer, AAC US would act as a principal and AAF would act as a reseller.

2. Additional considerations
Intercompany agreements should be drafted to formalize the intercompany arrangements. These may include a contract manufacturing services agreement, a know-how license agreement and supply/distribution agreements.
3. Transactions to be imposed

The IRS could impose a royalty to be paid by AACL to AAC US if AACL is characterized as a full-fledged licensed manufacturer.

If AACL is operating at a loss, the Chinese tax authority could impose a contract manufacturing arrangement where AACL would earn cost plus a mark-up.

D. Sale of valves from AACL to third-party Chinese customers

1. Summary

“AACL sells the Fetzer valves it manufactures to … AACL’s own customers in China.”

As discussed in Section I.A.1., there are several possible approaches to address this intercompany transaction:

Option 1

AACL could be characterized as a pure contract manufacturer, and AAC US could be characterized as an entrepreneur/principal. In this scenario, AACL would produce finished valves on behalf of AAC US, and AAC US would make sales to third-party Chinese customers. AACL would earn a routine return, e.g., cost plus mark-up, consistent with that of third-party manufacturing services providers.

Option 2

AACL could be characterized as a full-fledged licensed manufacturer, and AAC US could be characterized a licensor. Under that scenario, AACL would pay AAC US a royalty, as a percentage of net sales, on AACL sales to third-party Chinese customers.

2. Additional considerations

Since AACL is selling to third parties under the Acme trademark/trade name, it may be appropriate to pay AAC US a trademark royalty. This will depend on the perceived value of the existing marketing intangibles in AACL’s region. To maintain ownership of future developed marketing intangibles, AAC US could compensate AACL for its marketing and advertising activities that contribute to marketing intangible value.

Intercompany agreements should be drafted to formalize the intercompany arrangements. These may include a contract manufacturing services agreement, a know-how license agreement, a trademark license agreement and a supply/distribution agreement.

3. Transactions to be imposed

The IRS could impose a royalty for know-how and marketing intangibles to be paid by AACL to AAC US if AACL is characterized as a full-fledged licensed manufacturer.

If AACL is operating at a loss, the Chinese tax authority could impose a contract manufacturing arrangement where AACL would earn cost plus a mark-up.

E. Sale of AACL-produced valves to AAF

Refer to Section II.B. below

F. Sale of valves from AAC US to AACL

1. Summary

“Given China’s growing aerospace industry, AACL also purchases other variations of Fetzer valves from AAC US’ St. Louis plant for resale to third-party aerospace companies in China.”

For this transaction, AACL could be characterized as a distributor, with AAC US characterized as a full-fledged manufacturer/entrepreneur.

As discussed in Section I.D.1., AACL may need to compensate AAC US for the use of marketing intangibles. Compensation for use of marketing intangibles...
may take the form of a royalty or a premium built into AAC US’ sales price to AACL.

2. Additional considerations
An intercompany distribution agreement and, potentially, a trademark license agreement should be drafted to formalize the intercompany arrangement.

3. Transactions to be imposed
Both the IRS and Chinese tax authority would likely expect that AACL earns a routine return for its resale activity.

The IRS could impose a royalty for marketing intangibles to be paid by AACL to AAC US if AACL’s return appears excessive.

G. Management services from AAC US to AACL

1. Summary
It is not uncommon for subsidiaries to receive back-office and other management support from their parent company. If management activities performed by AAC US to AACL are beneficial, nonduplicative and not stewardship related, it may be appropriate for AAC US to charge AACL a service fee.

If AACL acts as a pure contract manufacturer, it could be acceptable to not include a management services charge from AAC US, as the addition of these costs would create circularity in the cost plus mark-up transfer pricing mechanism, i.e., double mark-up.

2. Functional analysis questions
Has AAC US charged AACL for management services in the past?

How have these charges been determined?

What management functions does AAC US perform that benefit AACL?

What management functions does AACL perform for itself?

3. Additional considerations
An intercompany management services agreement should be drafted to formalize the intercompany arrangement.

“Management” fees are not deductible for China income tax purposes, but “service charges” may be deductible. Although the services may be performed entirely outside of China, a 5 percent China business tax would apply. Please consult your local Chinese tax advisor on this issue.

4. Transactions to be imposed
If AACL is characterized as a full-fledged licensed manufacturer, the IRS may incrementally adjust AAC US’ income to account for management services provided by AAC US to AACL.

H. Opportunities
The company could use a Hong Kong holding company (HK Holdco) to take advantage of Hong Kong’s lower
corporate tax rates. HK Holdco would act as the regional entrepreneur, with AACL acting as a contract manufacturing services provider. HK Holdco would take title to the goods produced by AACL and resell to third parties and related parties. Subpart F issues may be triggered which requires consulting by tax advisors knowledgeable in this area. Transfer of intangible property to HK Holdco would need to be addressed.

II. ACME Aerospace France Sarl (AAF)

A. Transfer of client relationship from AAC US to AAF

1. Summary

“…AAC US’ sales personnel won a large contract with Airbus (EADS) in 2007…”

Because AAC US won the contract with EADS, there has been a transfer of marketing intangibles, i.e., customer relationship, from AAC US to AAF for which AAC US should receive compensation. Compensation may be in the form of a royalty, as a percentage of net sales, or a premium on the price of goods sold by AAC US to AAF.

2. Functional analysis questions

What do AAC US and AAF do to maintain and sustain the relationship with Airbus?

Was there any sort of compensation by AAF to AAC US for the customer contract?

B. Sale of AAC US and AACL-produced valves to AAF

1. Summary

“AAF purchases Fetzer valves from AAC US’ St. Louis plant and from AACL’s Suzhou plant and resells them to Airbus for use in production of its commercial airplanes.”

For AAC US-produced valves, AAF could be characterized as a reseller/distributor, and AAC US could be characterized as a full-fledged manufacturer/entrepreneur.

For AACL-produced valves resold by AAF, there are two possible approaches. In each approach, AAF would be characterized as a reseller/distributor. If AACL sells valves directly to AAF, AACL could be characterized as a full-fledged licensed manufacturer, and AACL would need to compensate AAC US with a royalty to exploit the valve know-how. If AAC US invoices AAF for AACL-produced valves, AACL could be characterized as
a contract manufacturing services transaction provider with AAC US acting as a principal.

Acme could also consider alternative scenarios. AAF could also be characterized as a commissioned agent or a customer support services provider. As a commissioned agent, AAF would earn a commission as percentage of net sales. As a customer support services provider, also known as pre- and post-sales support services provider, AAF would earn cost plus a mark-up.

2. Functional analysis questions
   What functions does AAF really perform?
   How many people does it employ?
   Does AAF have a warehouse or take on significant inventory levels/risks?
   What is the title flow for valves produced by AAACL?

3. Additional considerations
   Intercompany agreements should be drafted to formalize the intercompany arrangements, e.g., sales/distribution agreements, license agreement and contract manufacturing agreement.

4. Threats/challenges
   “For the fiscal year ended December 31, 2010, AAF earned a pre-tax operating margin of 25.4 percent on its purchase and resale of Fetzer valves purchased from AAC US and AAACL.”

If AAF is a distributor, commissioned agent or customer support services provider, the 25.4 percent operating margin is likely to be considered unacceptably high by the U.S. and/or Chinese tax authorities—especially given the functions performed and risks assumed by AAF. AAF does not appear to have developed the customer relationship and doesn’t appear to add much intangible property (IP) or value-add. AAF’s profitability for earlier years, e.g., 2007 and 2009, should be reviewed for additional exposure.

There are also possible French customs issues. Earning excessive profits could mean AAF paid a lower than arm’s-length value for the imported valves. As such, AAF could have underpaid import duties. If customs officials and income tax officials communicate openly, inappropriate transfer pricing could result in customs exposures.
III. McHugh services company

A. Transfer of intangible property

1. Summary

McHugh US created and maintained a services database benefitting McHugh affiliates. This IP has allowed McHugh foreign affiliates to earn significant margins for provision of valve maintenance services. For past years, McHugh US should have received compensation for providing this IP to the foreign affiliates. The IRS could impose a royalty to determine additional U.S. tax.

Now that the foreign affiliates are contributing to the service database, McHugh could take two approaches. Under a licensing arrangement, McHugh US could pay the foreign affiliates a contract research and development (R&D) fee, keeping worldwide IP ownership with McHugh US. The foreign affiliates would then pay McHugh US a royalty for use of the IP. Alternatively, McHugh could use a cost-sharing model, which would allow the McHugh affiliates to have exclusive, nonoverlapping IP rights in their respective territories. The McHugh affiliates would pay a portion of the total intangible development cost (IDC) based on each entity’s reasonably anticipated benefits (RAB). A cost-sharing arrangement would require a PCT, also known as a buy-in payment, from the foreign affiliates for existing IP owned by McHugh US.

2. Functional analysis questions

Has McHugh US been compensated in the past for its provision of IP to the foreign affiliates?

Do the McHugh foreign affiliates actively sell the services or are their customers referred to them by Acme entities?

Who enters into service contracts with the third-party customers? Is it the local service affiliate or the principal, e.g., McHugh US or AAC US? Should the local service affiliates be treated as subcontractors?

How profitable are the foreign affiliates?

Do the McHugh affiliates receive any management support from McHugh US? If so, which entity performs the services?

Does AAC US provide any management support to McHugh US?

Are McHugh employees shared among the different McHugh affiliates?

3. Additional considerations

Intercompany agreements, e.g., license, cost-sharing, and contract R&D services, should be drafted to memorialize the intercompany arrangements. The cost-sharing agreement is a specified documentation requirement for U.S. tax purposes.

AAC US/McHugh US must disclose the cost-sharing arrangement to the IRS annually. Cost-sharing statements providing certain details must be included in AAC US tax returns. All parties to the cost-sharing arrangement require U.S. tax EIN and a Form 5471.

Are there any ways to consolidate multiple entities in the same country to simplify the organizational chart? Are many of these entities dormant?

If McHugh employees are shared among the different McHugh affiliates, are there permanent establishment issues to be considered for longer projects?

4. Transactions to be imposed

The IRS could impose a royalty to be paid by the McHugh affiliates to McHugh US.
IV. Royal Corporation

A. Cost-sharing arrangement between AAC US and AACC

1. Summary

Under a cost-sharing arrangement, two or more entities would jointly develop IP, i.e., software, and each would maintain exclusive, nonoverlapping rights to exploit those intangibles in their respective territories. Ongoing IDCs would be shared by participating entities in proportion to RABs to be obtained from exploiting the IP. If intangibles exist prior to entering the cost-sharing arrangement, the new owners will be required to make a PCT, or buy-in, to purchase rights to the existing IP.

2. Functional analysis questions

What function/substance does AACC have with respect to this cost-sharing arrangement?

What charges have occurred to date with respect to the cost-sharing arrangement?

Was the acquisition structured as an asset or stock purchase?

How are IDCs allocated between AAC US and AACC?

Is it reasonable that the third-party valuation firm’s valuation report didn’t assign any value to the pre-existing IP?

B. Additional considerations

Intercompany agreements (cost-sharing and contract R&D services) should be drafted to memorialize the intercompany arrangement. The cost-sharing agreement is a specified documentation requirement for U.S. tax purposes and will require specific considerations to meet the strict documentation requirements for cost-sharing arrangements.

AAC US/Royal must disclose the cost-sharing arrangement to the IRS on an annual basis. Cost-sharing statements providing certain details must be included in AAC US tax returns. All parties to the cost-sharing arrangement require U.S. tax EIN and a Form 5471.

C. Threats and challenges

Cost-sharing arrangements are a Tier 1 transfer pricing issue for the IRS. These arrangements are subject to heightened scrutiny and require formal disclosure to the IRS.

The U.S. tax authority would likely argue there was value related to the existing IP. The third-party valuation firm likely did not address the IP value specifically and probably accounted for the IP value in goodwill. Another possibility is the valuation firm used alternative valuation rules, such as book valuation, which could assign very little value to IP. It is very unlikely the third-party valuation firm addressed the IP value separately and concluded that no value should be attributed to the IP. The U.S. transfer pricing rules have very specific methodologies for valuing IP. The IRS would argue AAC US is entitled to a PCT from AACC. AAC US likely has created some IP value in the past year for which it should be compensated.

In addition, AACC is located in a tax haven and arguably has minimal economic substance. The IRS could collapse the structure, attributing all IP rights to AAC US.

D. Opportunities

Given the level of scrutiny related to cost-sharing structures and the IRS’s increased focus on the level of economic substance for all participants, AAC US should consider alternative affiliates in establishing a cost-sharing arrangement. For example, AAC has
recently created AAC Zurich and ACC Singapore, which have more economic substance than AACC. AAC could establish a cost-sharing arrangement to establish these three regional IP owners:

- AAC US: North America
- AAC Zurich: EMEA
- AAC Singapore: Asia

E. Transactions to be imposed

The IRS could collapse the structure and impose a royalty to be paid by the foreign affiliates to AAC US.

V. Acme Brazil (AABL)

A. Provision of pre- or post-sales support by AABL to AAC US

"AAC US sells the Fetzer valves directly to Embraer, while AABL provides customer service to Embraer."

AABL provides pre- and post-sales support to AAC US with respect to Brazilian customer Embraer. AAC US sells directly to Embraer, and AABL does not take title to any inventory. AABL should earn a services fee, e.g., fully loaded costs plus a mark-up, from AAC US for its activity.

B. Additional considerations

An intercompany services agreement should be drafted to formalize the terms of the intercompany relationship.

The Brazilian regulations do not adhere to the arm's-length standard, which is the foundation of the U.S. transfer pricing rules and the OECD Transfer Pricing Guidelines.

It needs to be verified that a cost plus mark-up arrangement is permitted under Brazilian transfer pricing rules.

Are there customs or withholding tax issues?

C. Threats and challenges

AABL began operations in 2008; however, it hasn't recorded any profits to date. As a service provider, AABL should earn a return on its costs or a commission that enables it to earn a profit, so its taxable income is likely understated from a Brazilian tax perspective.

This arrangement may create a permanent establishment for AAC US. There should be a review of local tax law and treaties to assess this exposure.

D. Transactions to be imposed

The Brazil tax authority could recharacterize AABL as a commissioned agent or reseller.

VI. Acme Zurich and Acme Singapore

A. Opportunities

As regional headquarters, Acme Zurich and Acme Singapore will likely provide regional management services to AAF and AACL, respectively. It would be appropriate for Acme Zurich and Acme Singapore to receive service fees for their back-office activities performed on behalf of AAF and AACL, if applicable.

Acme Zurich and Acme Singapore could act as regional IP owners as part of a geography-oriented principal structure. They could be know-how IP owners as participants in the cost-sharing arrangement with AAC US. They could also be owners of foreign customer contracts and record all third-party revenue outside the U.S. The remaining entities would be considered service providers earning a return on operating costs. Acme Zurich and Acme Singapore would be good candidates for this structure since they have substance by employing key decision makers for their respective regions.

A cost-sharing arrangement would require PCTs by Acme Zurich and Acme Singapore to AAC US.

There would be a transfer of customer relationships, and perhaps brand IP, to the foreign principals that would need to be addressed.

B. Additional considerations

Intercompany agreements should be drafted to formalize the intercompany arrangements.
C. Transactions to be imposed

The Swiss and Singaporean tax authorities could impose a management fee for services provided by Acme Zurich and Acme Singapore to AAF and AACL, respectively.

V. Importance of Transfer Pricing

A. Tax purposes

1. Transfer pricing compliance

The United States and many developed nations (including those in which company subsidiaries operate) have transfer pricing rules and accuracy-related penalties for multinational corporations engaging in cross-border transactions.

Transfer pricing rules allow relevant tax authorities to make income allocations between or among the members of a controlled group if a controlled taxpayer has not reported an appropriate taxable income. In determining the level of appropriate taxable income, the tax authorities will typically apply the arm’s-length standard, which is the outcome that would have been realized if uncontrolled taxpayers had engaged in the same transactions under the same circumstances.

Taxpayers found to be negligent or requiring adjustments above certain thresholds will be subject to nondeductible pricing accuracy-related penalties. For example, in the U.S., penalties may be from 20 percent to 40 percent of additional taxes payable that result from a transfer pricing “misstatement.” As an additional example, the United Kingdom’s tax authority may levy maximum penalties equivalent to 100 percent of underpaid taxes, and interest also may be applied to the unpaid taxes. A more dire consequence of a transfer pricing adjustment will be double taxation, as the company paid tax for the same income in the corresponding jurisdiction. The ability to gain relief from double taxation may not exist or relief may not be granted. Mutual agreement procedures also are time consuming and expensive.

To comply with transfer pricing regulations and avoid penalties related to transfer pricing valuation misstatements, a taxpayer must make reasonable efforts to establish the arm’s-length nature for its intercompany pricing policies. This requires both the creation and maintenance of contemporaneous transfer pricing documentation on an annual basis and the proper implementation of transfer pricing policies. The documentation must exist before filing income tax returns so as to attest the accuracy of the return.

2. Schedule UTP

On September 24, 2010, the IRS released final instructions for Schedule UTP, which requires U.S. taxpayers to report uncertain U.S. tax positions on their federal tax returns. Taxpayers will be required to rank these uncertain tax positions (UTP) issues based on the U.S. federal income tax reserve recorded for the position taken in the return, including interest and penalties. Taxpayers also must designate those tax positions for which reserve exceeds 10 percent of the aggregate amount of the reserves for all uncertain tax positions reported.

The UTP filing requirement will be phased in over five years. Corporations with total assets equal to or exceeding $100 million, $50 million and $10 million must file Schedule UTP beginning in the tax years 2010, 2012, 2014, respectively. Only corporations that recorded a reserve with respect to a tax position in audited financial statements or did not record a reserve because the corporation expects to litigate the position must report such positions. For UTPs related to transfer pricing, the taxpayer must write “T” followed by a number to indicate a ranking of that position among all other uncertain tax positions.

B. Book purposes

Under FIN 48, public and private companies in the U.S. are required to analyze all tax positions that are less than certain. For positions not more likely than not to be sustained, a taxpayer must calculate and record tax liabilities associated with these positions. Increased tax reserves resulting from an uncertain position will affect the taxpayer’s income statement as opposed to owners’ equity.

Intercompany transactions should be analyzed and documented to mitigate risks for income adjustments by tax authorities that could result in additional tax, penalties and interest.
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With more than 17 years of dedicated transfer pricing consulting experience, primarily with large national accounting firms, Will advises clients on solutions to various transfer pricing and tax valuation issues.

Will has experience in transfer pricing planning, documentation, advance-pricing agreements, intellectual property valuation, cost-sharing arrangements and transfer pricing controversy for clients in a number of different industries. He spent three years in the United Kingdom gaining knowledge of transfer pricing under the Organization for Economic Cooperation and Development Guidelines, in addition to his knowledge on U.S. Internal Revenue Code Section 482.

He is a frequent speaker on transfer pricing topics at outside tax seminars, including the Council for International Tax Education, the Tax Executives Institute, World Trade Centers, INFONEX and the St. Louis International Tax Group. He has also presented on various transfer pricing topics in Canada, China, Israel, Japan, Singapore and throughout Europe. Will currently serves as the Global Chairman of Praxity, AISBL’s Transfer Pricing Expert Working Group.

Will is a 1991 graduate of Lake Forest College, Lake Forest, Illinois, with a B.A. degree and a 1997 graduate of Northeastern University, Boston, Massachusetts, with an M.B.A. degree in finance and international business.

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