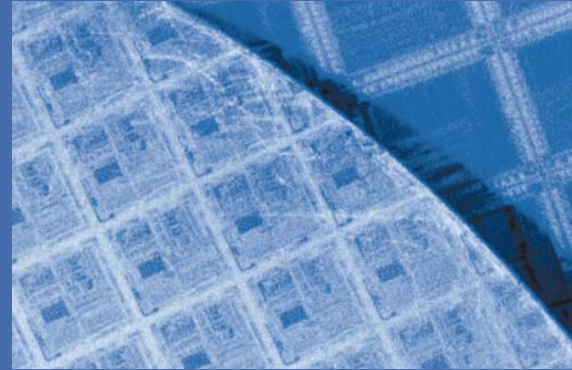




INFORMATION, COMMUNICATIONS & ENTERTAINMENT

# Improving Transfer Pricing Risk Management in High-Technology Companies

TAX



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# Introduction



“Once you take on board the fact that more than 60 percent of world trade takes place within multinational enterprises (MNE), the importance of transfer pricing becomes clear....Transfer prices are useful in several ways. They can help an MNE identify the most and least efficient parts of the enterprise. Furthermore, an MNE could suffer double taxation on the same profits without proper transfer pricing.”

Organisation for Economic Co-operation and Development's Centre for Tax Policy and Administration

Companies in high-technology industry segments, including software, semiconductor, and the broad array of electronics manufacturers the world over, today share a common—and pressing—tax challenge: Understanding and managing the risks and opportunities presented by the increasing number of transfer pricing rules and regulations worldwide.

This paper provides a new perspective from KPMG LLP in the United States on these issues, and can serve as a catalyst for executive-level discussion and improvement within the enterprise. This discussion can include integrating transfer pricing risk management with remediation and sustainability as part of an overall effort to bring about improvements in the corporate tax function.

## The global imperative

With rapid globalization, high-tech companies may view national boundaries as less relevant to how they conduct business. Taxing authorities, however, do not see things in quite the same way. They zealously guard the tax base of their respective countries, as evidenced by new or expanded transfer pricing legislation and rules that are in place in an estimated 50 such jurisdictions. Tax authorities across

the globe are beginning to recognize the significant revenue opportunities presented by high-technology companies that routinely move assets between jurisdictions in the normal course of adding value to the products they develop, produce, and sell. This increased interest in transfer pricing by local authorities has heightened compliance requirements and the need for transfer pricing awareness by high-tech multinational companies.

It was not too long ago that the subject of transfer pricing and the resulting tax implications might be discussions reserved only for a very few tax specialists in the multinational corporation. But, those days are gone. A broader audience is now required to ensure that tax considerations are a holistic part of both strategic and tactical decision making in today's high-technology enterprise.

Though it is a subject fraught with complexity, transfer pricing policies and strategies deserve thorough discussion in boardrooms at the audit committee level, and within middle and upper-level management teams throughout the high-tech industry. Multinational corporations that do not appropriately focus on transfer pricing strategy, policies, and importantly, documentation, do so at their own peril. The negative impact resulting from transfer pricing actions by taxing bodies can include high costs associated with audits, negative publicity and the potential for declining market capitalization, income adjustments by taxing authorities, and lingering poor public image around the globe.

Many multinational corporations have recognized the importance of transfer pricing to varying degrees. Some have placed this topic among their most important international tax issues and have dedicated the necessary management-level resources, and have garnered senior-management attention. According to Fred Mazurek, tax vice president for Beckman Coulter Inc., “Transfer pricing issues can no longer be addressed only by tax executives at the corporate headquarters level. These discussions need to be held throughout the organization. Transfer pricing is now one of the top tax issues at high-tech companies.”

Some multinationals, however, are still in a reactive mode, grappling with the expanding international nature of their operations while at the same time attempting to address ever-increasing regulatory and documentation requirements. All multinationals should be aware that transfer pricing is an area requiring much more of their attention than was required in just the past couple of years.

### Arm’s-length principle

The central premise of most nations’ transfer pricing regulations rests upon the “arm’s-length principle.” This principle is the international standard for the Organisation for Economic Co-operation and Development (OECD) member countries and requires that pricing for transfers of goods, intangibles, services, or intellectual property between affiliated companies be consistent with what would be applied to transfers of the same goods, services, or intellectual property between independent organizations under similar conditions. To the extent that conditions are made or imposed between affiliated enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would have accrued to one of the enterprises, but, by reason of those conditions, then such profit may be included in the profits of that enterprise and taxed accordingly.

The transfer pricing challenge for a global high-tech manufacturer today is managing the ever-changing business environments of the multitude of countries in which it locates its tangible property, intangible property, research and development resources, information technology, and human capital. As company structures become ever more multifarious, it is critical that their transfer pricing policies and agreements keep pace.

The new global tax environment has heightened the importance of viewing transfer pricing from both a strategic and an operational perspective. According to Tyler Painter, corporate treasurer and vice president investor relations and tax for

Wind River, “In the past, high-tech businesses often did not have centrally coordinated transfer pricing documentation and strategies, primarily because businesses were rapidly becoming global organizations through a combination of M&A as well as organic growth. In many cases, their supply chains were built quickly, and tax issues were given insufficient consideration. The global tax compliance environment today demands heightened focus and clearly defined processes.”

In today’s business environment, investors, corporate executives, and board members increasingly demand better insight into the tax environment because of the potential for material impacts on financial statements. Just as regulations and laws have had the effect of raising the profile of tax, so too have investors and the media. A recent paper published by Henderson Global Investors, for example, takes the position that, “it is right and proper for investors to seek assurance that risks in this area, just as in any other, are being appropriately identified, assessed, and managed.”<sup>1</sup> Similarly, an opinion piece in the *Financial Times* held that “the trend for more aggressive tax planning has been countered by a widespread clampdown by tax authorities. The resulting fallout has made tax a potential source of litigation, unforeseen costs, and embarrassment. Yet many companies still view tax as largely an operational matter.”<sup>2</sup>

Transfer pricing issues, and their impact on a company’s overall tax risk management activities, have taken center stage at a critical time in the high-technology industry.

<sup>1</sup> “Tax, Risk and Corporate Governance,” *Henderson Global Investors*, February 2005

<sup>2</sup> “Why Tax Is a Task for the Boardroom,” Vanessa Houlder, *Financial Times*, March 3, 2005



# Current Transfer Pricing Environment



As the number and scope of intercompany transactions continue to proliferate in the expanding global economy, the frequency of tax audits relating to transfer pricing is increasing, particularly in the high-tech sector.

Penalties and assessments resulting from these audits can be significant. Against the backdrop of more-vigilant tax bodies around the world, businesses operating in the global high-tech industry are dealing with the transfer pricing implications growing out of ongoing mergers and acquisitions, joint ventures, and strategic alliances. This globalization of the industry combined with increased regulatory scrutiny and enforcement has propelled transfer pricing to a new level of importance on the tax agenda and indeed on the enterprise risk agenda as well.

While these forces have significantly altered internal transfer pricing requirements, it appears that some organizations may not be adequately prepared to take a holistic view of their transfer pricing risks. As a result, these businesses are discover-

ing that their processes for documenting and managing those risks may be fragmented, exposing them to potentially costly audits by tax authorities in numerous jurisdictions.

In some cases, businesses are unclear about the variety of transactions that may involve transfer pricing, particularly, for example, in areas such as intangible property, research and development activities, and intercompany service activities, such as head-office or cross-border engineering services.

Contributing to the increased importance of transfer pricing in the high-tech industry are a number of key elements:

- New and expanded transfer pricing legislation in a growing number of countries

- Global enforcement and a demand for more thorough documentation relating to transfer pricing activities
- Increasing ranks of government auditors who are well trained in the technical aspects of transfer pricing
- Complex issues and transactions resulting from the growing number of locales housing tangible property such as plant

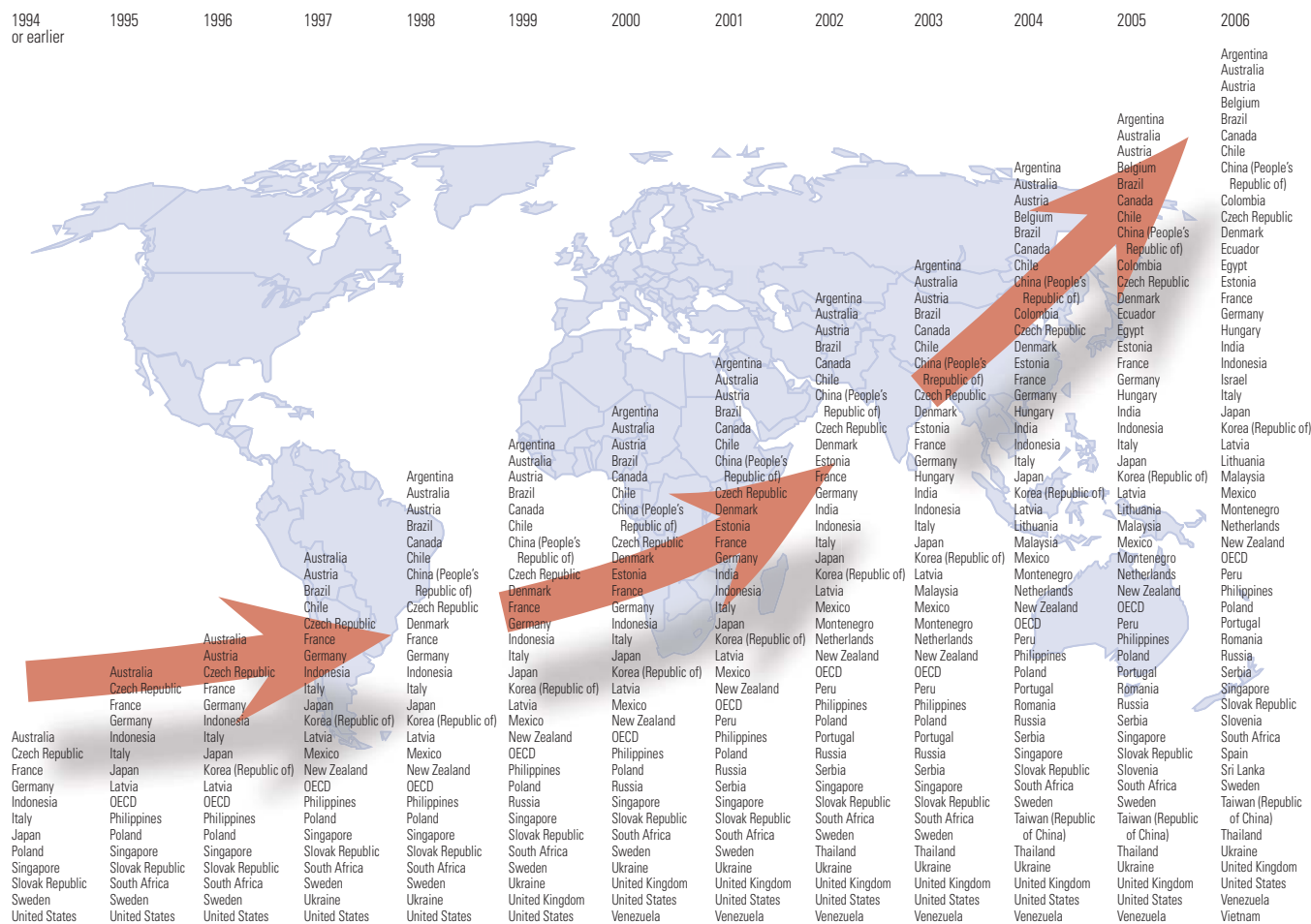
and equipment, the location of service providers throughout the organization, and, most importantly, the location and ownership structure of intellectual property.

The transfer pricing compliance environment has radically changed in a relatively short period of time. The list of nations that have imposed transfer pricing compliance

requirements continues to grow, as evidenced in the diagram below, and with this phenomenon there is a new and urgent focus on the documentation of transfer pricing practices and policies of multinational companies. Hence, the need for globally consistent processes to create, share, and archive documentation has become critical.

The list of countries that have imposed transfer pricing rules has increased dramatically in the past decade.

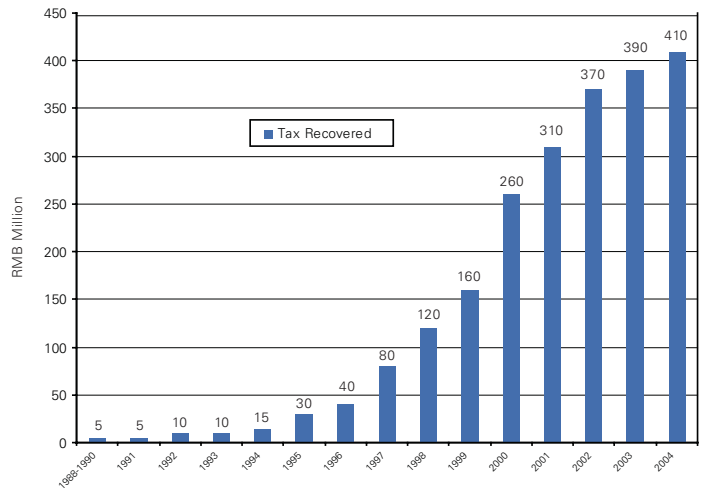
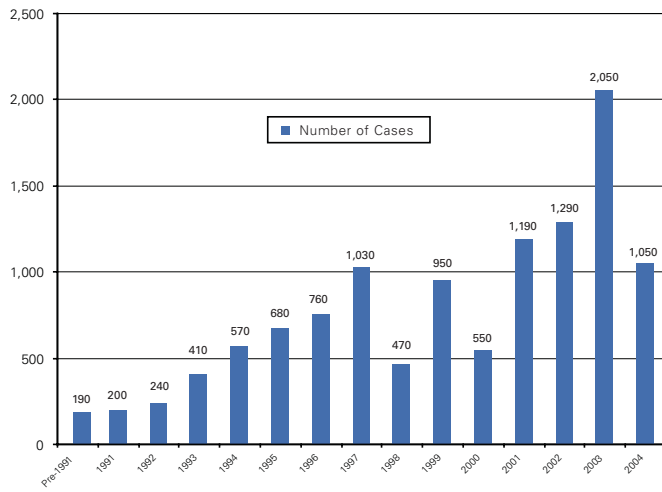
## Global Transfer Pricing Rules and Enforcement



Source: KPMG LLP (U.S.), 2007



### Transfer Pricing Enforcement in China



Source: KPMG Huazhen, 2006

The illustration above illustrates the stepped-up enforcement in the global transfer pricing arena. In this case, China's focus on transfer pricing enforcement has produced some startling results in the level of enforcement and the resulting tax recoveries. However, China is only one of many nations increasing its tax-enforcement focus.

As many companies that have been subjected to tax audits can attest, countries no longer act in isolation when it comes to enforcement of transfer pricing tax matters. As the list of countries that adhere to the OECD guidelines on transfer pricing grows, countries tend to monitor audits and sanctions imposed by other countries, particularly if the countries share treaties.

There was a time in the not-too-distant past when complex transfer pricing issues might have been too difficult for some nations' taxing authorities to evaluate. Now, through training and experience, complexity rarely dissuades taxing authorities from moving forward and challenging transfer pricing transactions, which can result in costly audits.

# Areas of Heightened Transfer Pricing Risk

There are a number of significant risks related to transfer pricing, and organizations may want to consider if any of the following apply to them.



Source: KPMG LLP (U.S.), 2006

When an organization establishes its transfer pricing policies, it should keep in mind that taxing authorities in nearly all industrialized countries and in a great many developing countries may demand documentation that describes the intercompany transactions and provides the functional and economic analysis supporting the arm's-length nature of the transfer pricing policies.

Without such documentation, an organization may have difficulty supporting its pricing decisions and therefore increase its exposure to transfer pricing adjustments, consequent tax assessments, and possible penalties. The taxpayer in this case is further weakened by being in a defensive position, reacting to proposed adjustments by the taxing authority. In some jurisdictions, the existence of documentation shifts the burden of proof that pricing is appropriate from the taxpayer to the tax authority. A number of jurisdictions even apply penalties for the lack of documentation, regardless of any potential transfer pricing adjustments.

## Tone at the top

Given the increased seriousness of transfer pricing issues, senior management and board members should seek to assure themselves that their organization has evaluated the tax implications of its worldwide transfer pricing activities. Doing so is a useful first step in determining whether transfer pricing risks exist and whether those risks have been properly documented and rigorously evaluated by experienced personnel. Establishing whether such an evaluation has been performed is also an important consideration under management's responsibility for establishing and maintaining adequate internal control over financial reporting as required for U.S. Securities and Exchange Commission registrants by the Sarbanes-Oxley Act of 2002.

“Tax issues associated with the transfer of intangibles outside the United States have been a high risk compliance concern for us and have seen a significant increase in recent years. Taxpayers, especially in the high-technology and pharmaceutical industries, are shifting profits offshore through a variety of arrangements that result in the transfer of valuable intangibles to related foreign entities for inadequate consideration. Cost sharing arrangements are often the method of choice for this activity. The buy-in amount in cost sharing arrangements is particularly troublesome. It is often understated, resulting in the improper shifting of income offshore.”

Mark Everson  
Commissioner of Internal Revenue Service  
June 13, 2006

Written testimony before Senate Committee  
on Finance on Compliance Concerns

## Getting started

A rigorous evaluation begins with an inventory of all significant related-party transactions. Though such a task may be time consuming, it allows those who need assurance to have clarity on the critical activities that present significant risks. Undertaking an inventory of related-party transactions is useful in terms of getting a clear sense of how the business is operating and may identify exposures to transfer pricing risks. It also allows the taxpayer to identify which transactions it should focus on in order to prepare transfer pricing documentation most efficiently. That is, a large share of the value of related-party transactions (and transfer pricing risk) may be accounted for by a relatively small number of transactions. This exercise would focus a company's limited

resources to get the most advantage from performing the analysis. Outside advisers can help an organization identify those transactions requiring heightened care in documentation due to a higher risk of scrutiny or challenge from tax authorities. Such an analysis would likely be based on a number of factors in addition to value, such as profitability of the transaction or share of total sales or purchases. Taxpayers should also consider any related-party transactions that have not historically been charged and, thus, would fall outside of a cataloging effort based on transaction value. Indeed, care needs to be taken in using transaction value as a measure of importance as the value depends on the transfer pricing. Thus, if the transfer pricing is distorted, transaction value may not be the best measure of a transaction's importance.

As noted in the discussion by IRS Commissioner Mark Everson, U.S. high-tech firms are under increasing scrutiny with respect to how they have structured and located their intangible property. New rules related to cost sharing are expected in 2007 to provide further guidance and less tolerance for valuation methods that do not conform to the IRS view of who is responsible for creation of intellectual property (IP) value. For example, if the proposed rules are finalized, it may become infeasible or unattractive to implement a transaction involving the joint development of future IP that relies upon buying into pre-existing U.S. IP. This is because current methods that are used to value the transfer of rights to foreign related parties will be replaced with methods likely to determine higher payments for intellectual property. The proposed rules will seek to limit the profit attributable to foreign investors in accordance with what a rational investor would expect to earn from an external transaction.

These proposed changes may therefore make it less appealing for U.S. firms to maintain valuable IP offshore. Certain aspects of the proposed cost sharing rules will also make it more difficult to integrate new acquisitions into existing cost sharing arrangements, increasing the need to consider transfer pricing issues more carefully as part of the transaction due diligence process.

The importance of transfer pricing to the transaction due diligence process has been highlighted by several cases where the IRS has proposed very significant adjustments to companies based in Silicon Valley who have merged or acquired entities with foreign-held IP.

It is also of note that the IRS recently issued new temporary services regulations and these rules will be effective for tax year 2007, requiring substantial changes to how companies document their intercompany services transactions. These new rules will make it more important to document costs in the United States that are not charged out to foreign-related parties because the IRS is seeking to expand the pool of costs that is considered to benefit foreign subsidiaries. Therefore, it will be even more important to document the services provided so that such costs are more likely to survive as deductions in foreign subsidiaries. Finally, these new rules require including stock-based compensation in the pool of costs considered for charge-out. Therefore, it will be important to consider the impact of this requirement on the ability to deduct such costs in foreign subsidiaries.

# An Approach to Managing Potential Transfer Pricing Risks: Leading Practices of Corporate Governance



No two high-technology multinational organizations engaging in transfer pricing are the same, and there is no standard, shrink-wrapped approach for discovering, managing, and mitigating the transfer pricing risks these organizations face.

There are some actions, however, that can act as a foundation to help an organization create a coordinated, global, cross-border transfer pricing process. Such a process can help maintain standardized, cost-effective, and consistent documentation for all of an organization's corporate entities while helping to ensure a globally and regionally consistent transfer pricing policy.

The organization should consider adopting a top-down approach to its transfer pricing policy, where senior management actively discusses and encourages debate regarding transfer pricing issues. When the discussion of transfer pricing and its impact on tax as a strategic issue emanates from the executive suite, it can help integrate tax as a business issue to be appreciated outside the confines of the tax department.

As an organization sets out to create a process for identifying and managing potential transfer pricing risks, it must consider that this activity will not be a self-sustaining process. Risk management requires ongoing nurturing activities. Below are some better-practice ideas that a high-technology company should consider in its transfer pricing risk-management activities.

## Establish solid transfer pricing policies

Transfer pricing policies should be based on thorough functional and economic analyses, which identify the value drivers, risks, and the location of company assets. The analysis must yield a story that is reasonable, rational, consistent, and economically credible to a taxing authority that may seek justification for an organization's cross-border transactions and transfer pricing.

ing policies. Companies should consider creating a transfer pricing manual. With a compelling story, and solid documentation, an organization can feel relatively comfortable presenting a legitimate case to a taxing authority. A well-thought-out approach can diminish the chances that a taxing authority would suspect a company is inadequately dealing with its transfer pricing obligations. Such documentation shows that a business is organized and prepared in case of an investigation by a taxing authority. It will also serve as supporting documentation for use by the company's auditors who are also responsible for independently evaluating tax risk and the potential for adverse tax assessments. The existence of transfer pricing documentation, alongside policy and procedures documentation, can streamline the discussions with your auditors as well as with the tax authorities.

## Establish a cross-function transfer pricing team

(An example of a typical cross-function transfer pricing team can be found in the Appendix.)

Ongoing policy compliance monitoring is critical to demonstrating appropriate governance over transfer pricing. Many companies establish a team to perform this function, and the most sophisticated approach involves a team that includes members from across all the functions that have a stake in transfer pricing. Organizations may also consider having a senior steering committee provide oversight and guidance to the team. Team composition may include representatives from the following areas, as well as members with global business experience and outside advisers:

- Tax
- Finance

- Accounting
- Legal
- Information technology
- Customs
- Operations executives with global business experience
- Outside advisers

A team that covers a number of functional areas can help drive awareness and knowledge of transfer pricing throughout the organization. Since transfer pricing covers all facets of a business, a broad-based team can also help address the myriad non-tax-related issues.

## Execute intercompany agreements for related-party transactions

An important extension to establishing solid transfer pricing policies is implementing intercompany agreements. Such agreements can provide support for the economic substance of the transactions. For example, an intercompany agreement typically would detail the responsibilities of the different parties and the risks borne by each, as well as the pricing of intercompany transactions.

Conduct a periodic assessment of possible transfer pricing risks and consider countermeasures. A program that assesses risks at scheduled intervals (with flexibility to react to changes in the business, regulatory, and legislative landscape) is a valuable asset. The program is ever more valuable if it has countermeasures, such as a method to readjust transfer prices, that help mitigate the risks that are identified during the assessment process. At a minimum, a company should evaluate its transfer pricing results annually.

## Respond to each country's documentation rules

An organization is well served to stay informed about transfer pricing rules in each country where it has related-party transactions. This activity may be time-consuming at the outset, but will likely become more routine in future years.

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For a country-by-country listing of transfer pricing rules visit [www.us.kpmg.com/services/GTPSReview](http://www.us.kpmg.com/services/GTPSReview)

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## Consider global or regional approaches to transfer pricing documentation as part of a global documentation strategy

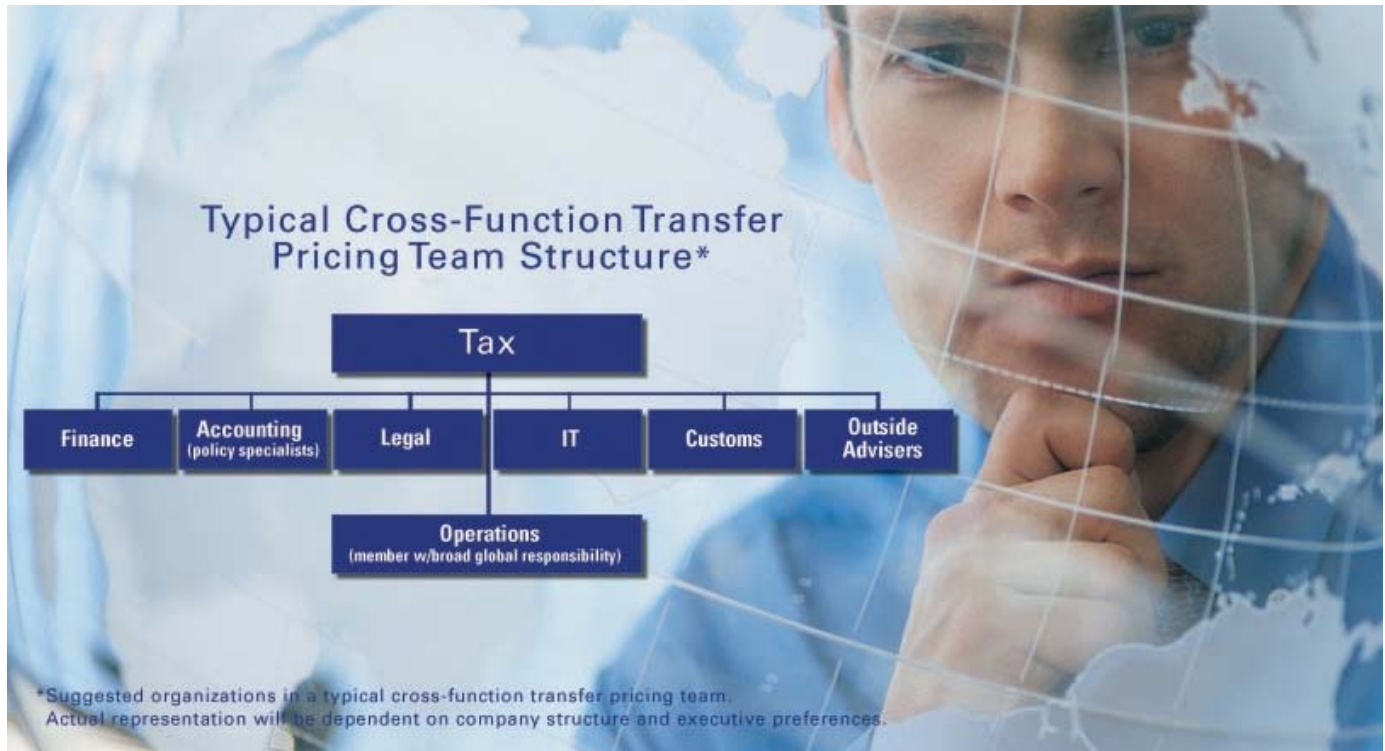
A coordinated approach to documentation within a multinational high-technology company or within a region, as part of an enterprise-wide, global strategy, can help provide consistency and efficiency. Often, a high-technology company's functions will be similar across countries in a particular region, or even globally. A global and regional assessment report can provide a consistent description of the operations and economic analysis of controlled transactions. The regional report can then be modified for the particular jurisdiction to satisfy local documentation requirements.

## Consider the APA process

An organization desiring a degree of certainty in its transfer pricing results may wish to consider an advance pricing agreement (APA). An APA is an agreement between a taxpayer and one or more taxing authorities that essentially provides a predetermined transfer pricing result and is based on certain critical assumptions over



# Appendix: Example of a Typical Cross-Function Transfer Pricing Team



Source: KPMG LLP (U.S.), 2007

## Tax

- Acts as project driver
- Ensures objectives are met
- Makes sure all tax requirements are met
- Handles notifications to tax authorities
- Provides documentation/defense

## Finance

- Advises on and develops solutions for management systems
- Addresses the ability of the financial reporting system to handle implications of transfer pricing
- Provides required financial data, including segmented data and budgets
- Assists in (or takes primary responsibility for) developing and running transfer pricing models

## Accounting

- Provides information on accounting systems, accounting rules, consolidation of accounts
- Administers invoicing/booking/settlement of intercompany payments

## Legal

- Oversees development of intercompany legal agreements and legal pricing requirements

## Information Technology

- Assists in developing software, a programming interface with the transfer pricing model, and an internal financial system

## Customs

- Assesses valuation, duty impacts, and representation and notification requirements

## Operations: Members with Global Business Experience

- Assist in determining foreign implications of transfer pricing policy
- Act as intermediaries between U.S. and foreign businesspeople
- May be structured similarly to U.S. core team

## Outside Advisers

- Brings industry best practices to the internal team
- Provides access to resources around the world experienced in International tax, transfer pricing, valuation, VAT, and customs
- Offers insight into expectations of auditors with respect to tax provision, including FAS 109, FIN 48, and Sarbanes-Oxley requirements



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