

The next unforeseen tax bill

Following recent cases in the US, companies in the UK should expect investigations into their transfer pricing strategies by the taxman, says **Thayne Forbes**



Legal agreements, reports and documents that justify a company's tax-related decisions, customer contracts and customers' compliance can now count for nothing in defence against accusations of irregular transfer pricing from the tax authorities. HM Revenue & Customs' enquiries are becoming more innovative and commercial and are based on good analysis and understanding of complex business arrangements, particularly involving intellectual property (IP).

It is therefore becoming much more risky for accountants in industry to rely on a file that supports transfer pricing strategies without considering the commercial substance behind them. These strategies should be fully thought out and commercially benchmarked and backed up. If not, there could be a big and surprising tax bill coming, as these examples from the US illustrate.

UPS, the global shipping company, incurred a large tax liability arising from transfer pricing for its brand. This originally arose because its standard terms and conditions for parcel deliveries limited the liability for loss and damage to \$100 for each

item. However, UPS also offered its customers optional insurance, which gave increased cover.

The relatively high profits from this insurance were remitted to Bermuda, a low-tax jurisdiction. Even though the amounts were separately agreed with customers, the Internal Revenue Service (IRS), the US tax authority, mounted a transfer pricing challenge on the basis that the sale of the insurance was made because of the original sale of delivery services under the UPS brand. So the brand drove the sale of the insurance, but there was no charge for the use of the brand from Bermuda to the US.

Bundling

Goods and services are often bundled in the market at prices that would not necessarily be at arm's length for the individual components. A common reason is that a purchase decision is often made on a lead item – in this case, parcel delivery. By the time extra cover for loss or damage is being considered, the decision has been made and the customer will be less inclined to look for alternatives, so the price of the additional cover will be higher.

There are other examples of this in the marketplace – for example, warranties sold with electrical appliances – and they are often referred to as 'bundling'. Based on transaction prices, the additional products or services would be much more profitable than the lead (loss leader) product. Another way of rationalising this would be to say that the loss leader's brand drives the sale of the whole bundle. If separated, there should then be a royalty to the brand for its contribution to the sale. It is a complex argument, but UPS faced a tax liability of billions of dollars as a result.

IP ownership

GlaxoSmithKline (GSK), the global pharmaceutical company, incurred a significant liability in respect of the ownership of its IP. Because of the importance of approval by the Food and Drug Administration (FDA) to the commercial success of a drug, GSK would normally bring out its new products in the US first. Critically, the significant expenditure to undertake the rigorous research over many years to prove a drug's worth was financed by the US subsidiary, while much of

the IP supporting these drugs was owned by non-US GSK companies.

The challenge made by the US tax authorities included the position that the FDA approval process was a significant contributor to the intangible value of the drug. As this expense was attributed to US companies, the transfer pricing mechanism should reflect this situation. The IRS claimed that it did not, and that profits were being transferred at non-arm's length prices. This was despite legal ownership of the IP not being in the US, and GSK companies in other countries also funding drug development. This meant that despite registered patents and trademarks being located in the UK, GSK could not charge a full transfer price into the US. It was a very hard line, but it contributed to GSK paying \$3.4 billion.

So companies and their accountants that do not carefully analyse their deployment of IP could have significant exposure. Given the importance of IP as a commercial asset, many leading-edge companies isolate and focus on developing it. This gives many commercial benefits and a reduced exposure to the huge IP transfer pricing bill should follow. As in many situations, focusing on the commercial substance should reduce unforeseen tax bills.

Accountants should consider the commercial substance behind transfer pricing strategies. If not, there could be a big and surprising tax bill coming

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