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The impacts of tariffs on transfer pricing

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Learning objectives

1

Define the new tariffs rules that have been enacted

2

Identify the impact the tariffs have had on transfer pricing methods

3

Cite the strategies companies are using for complying with transfer pricing and tariffs

Agenda

1

Overview of tariffs

- Where we are
- General discussion

2

Impact of tariffs on transfer pricing

- Direct impact on tested party results
- Comparability issues that undermine best method conclusions

3

Other impacts of tariffs

- CBP valuation issues
- Double-tax challenges

4

What companies are doing

- Mitigation of business impact
- Transfer pricing reporting



Overview of tariffs

Where we are

- Section 232 tariffs - 25% on steel; 10% on aluminum
- Section 301 tariffs - China produced goods
- \$50 billion at 25% (threatened at 30%)
- \$200 billion at 25% (threatened at 30%)
- \$300 billion threatened at 15%

- Total US tariffs applied exclusively to Chinese goods: **US\$550 billion**
- Total Chinese tariffs applied exclusively to US goods: **US\$185 billion**
- Focus at the moment is on China-US tariffs but the scope could expand to Europe, North America, etc.

How did we get here?

BEFORE...

“We can’t continue to allow China to rape our country and that’s what they’re doing. It’s the greatest theft in the history of the world.”

-Donald J. Trump (May 2, 2016)

AFTER...

“...I am a Tariff Man. When people or countries come in to raid the great wealth of our Nation, I want them to pay for the privilege of doing so. It will always be the best way to max out our economic power. We are right now taking in \$billions in Tariffs. MAKE AMERICA RICH AGAIN”

-Donald J. Trump (Dec. 4, 2018)

Overview of tariffs

“Tariff” is a duty overseen by the Customs and Border Patrol (“CBP”)

- Class of goods
- Country of origin (“CoO”) - where goods are manufactured

“Importer of record” initially bears tariff

- Attempt to pass tariff on to customers
- No prohibition against allocation of “tariff risk”

Tariff costs are captured in Cost of Goods Sold

Tariff impact could require transfer pricing adjustment

- Quantification is expected to be difficult



Impact on Transfer Pricing

How tariffs impact transfer pricing

1. Impact on tested party results
2. Challenges to comparability analyses and best method selection

Impact on tested party results

Forco sells goods to USco, wholly-owned U.S. distribution subsidiary

Arm's length range is operating margin (OM) of 2-4%
Before tariff

USco earned \$2.5M on \$100 M goods (2.5% OM)

\$10 M of goods are produced in China and subjected to 25% tariff (\$2.5 M)

No portion of tariff is passed on to third party customers
Tariff would reduce operating profit from \$2.5M to \$0.0

USco must make \$2M downward transfer pricing adjustment to move OM results into the range
(\$0.0+\$2M=\$2M or 2% OM)

Example 1

	Before Tariff	After Tariff
Sales	100	100
COGS	80	82.5
Gross Profit	20	17.5
SG&A	17.5	17.5
Operating Profit	2.5	0.0

Impact on tested party results

Example 1 compared the “OM of USco to the OM range of North American distributors.

A tariff not passed on to the customer produced a deterioration of the OM for the tested party (from 2.5% to 0.0%)

Even if passed on to the customer, OM declines.

In Example 2, a tariff is levied on all purchases from related parties (25% on 80)

Even if entire tariff amount is passed on to the customers, producing an increase in both Sales COGS, the OM deteriorates from 2.5% to 2.1%

Example 2

	Before Tariff	After Tariff
Sales	100	120
COGS	80	100
Gross Profit	20	20
SG&A	17.5	17.5
Operating Profit	2.5	2.5
Operating Margin	2.5%	2.1%

Challenges to comparability

U.S. transfer pricing regulations (Treasury Regs. [§ 1.482-1\(d\)\(1\)](#)) address comparability under the following broad factors:

- functions,
- contractual terms,
- risks,
- economic conditions, and
- property or services.

Tariffs impact the following three items:

<i>Contractual terms:</i>	How much flexibility is there in sourcing goods - duration, location, volume, etc.
<i>Risks:</i>	Market risk and financial risks are commonly noted – should customs/tariffs risk be added to the list?
<i>Economic conditions:</i>	Similarity of geographic markets, location-specific costs, and alternatives realistically available to the buyer and seller.

Application of best method

A. How comfortable are we with the selection of the comparables?

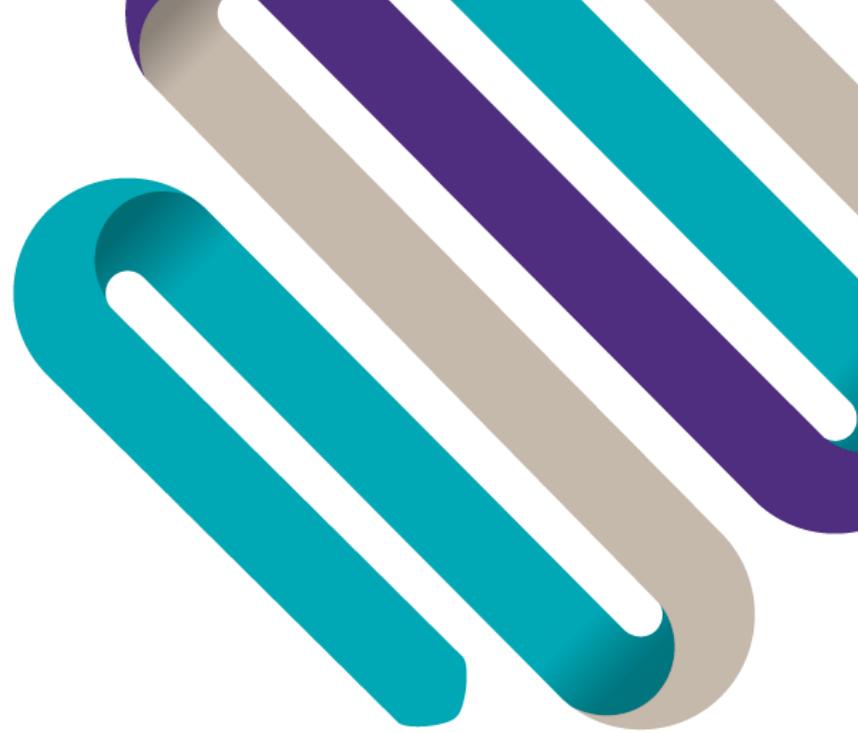
- Do we have enough information to make a reliable determination?
- Example: Is a distributor of goods made in China comparable to distributors sourcing goods from Vietnam and other countries in the region?

B. What about the financial data? Should we be comparing tested party data to those of the comparables?

- How much information do we have about supply chains, tariffs, etc. on the comparables?

C. What, if any, comparability adjustments can we make? What are the limitations?

- Should we compare results of tested party subject to tariffs to those with no tariffs?
- Should we carve out the impact of tariffs?
 - Tested party vs. comparables
- Timing of analyses – different tariffs have been enacted at different times → comparability issues



Other impacts

Customs Impact of Transfer Pricing Adjustment

Retroactive transfer pricing adjustments may alter customs value of previously imported goods, and must be reported

Adjusted transfer price must satisfy CBP's arm's length rules and methods (which are different than tax/IRC 482 methods)

If transfer pricing adjustment results in decrease in customs value, importer must satisfy CBP's 5-factor criteria to receive refund

Customs Impact of Transfer Pricing Adjustment

	Pre-tariff	Post-tariff (1)	Post-tariff (2)
Sales	100.00	100.00	100.00
COGS			
Transfer price	80.00	80.00	61.00
Tariff duty	-	20.00	15.25
Total COGS	80.00	100.00	76.25
Gross profit	20.00	-	23.75
SG&A	17.00	17.00	17.00
Operating profit	3.00	(17.00)	6.75
OM Range: 2-6%			
Required TP Adjustment (in COGS)	-	19.00	(0.75)
Potential Customs Refund	-	-	4.75

Double tax challenges

- New tariffs could drastically change transfer price
- Transfer pricing examinations could produce double taxation
- Mutual Agreement Procedure (MAP) allows treaty partners to negotiate to alleviate double taxation
 - **...but will other governments respect U.S.-imposed tariff?**
- How will the IRS react to transfer pricing adjustments due to retaliatory tariffs in other countries?



What companies are doing about it

Importer Efforts to Mitigate Tariffs

- Stockpile pre-tariff inventory
- Change suppliers
- Pass tariff on to customers by price increase
- Re-evaluate tariff classifications
- Stop sales of tariff-affected products
- Re-negotiate supply contracts
- Customs first-sale rule

Transfer Pricing Reporting

- Carve out tariff impact
 - Ideally from both tested party and comparables financials
- Carve out tariff impact for a limited period
 - Focus on tested party
- Advance pricing agreement
 - Build tariffs into negotiations with tax authorities

Concluding remarks

- Tariffs are likely to be the new reality, at least in the near future
- To manage uncertainty, companies should evaluate their options (supply chain, customer pricing, classifications, etc.)
- From a transfer pricing perspective, a re-evaluation of functions/risks/assets profile may be required
- Consider revising economic analyses to better align with the new business environment (e.g., re-examine the comparables benchmarking analyses)
- Finally, depending on the materiality of the tariffs impact, seek more certainty through an Advance Pricing Agreement

Any final questions?



Speakers



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WNTO National Technical Leader

- National Technical Leader of the transfer pricing practice, based in Wash. D.C.
- Holds J.D. and LLM degrees from University of Texas and NYU, respectively
- Globally-recognized expert with over 25 years of experience, including the IRS and Big 4 firms
- Adjunct Professor at NYU, author of best-selling book in transfer pricing, and active participant in conferences, seminars, and other transfer pricing events



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