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Best Practices for Transfer Pricing Due Diligence in International Mergers and Acquisitions

International mergers and acquisitions (M&A) have become increasingly popular among multinational enterprises (MNEs) seeking to expand their global footprint and increase their market share. However, such transactions also present significant transfer pricing challenges that can impact the deal valuation and create tax exposures. Therefore, MNEs must carefully evaluate the transfer pricing implications of M&A transactions to ensure they comply with relevant tax laws and regulations and effectively manage potential risks.

In the context of M&A, transfer pricing due diligence (TPDD) is a critical process that helps MNEs identify and manage transfer pricing risks associated with the target company. Failure to comply with transfer pricing regulations can result in significant tax assessments, penalties, and reputational damage. Therefore, it is vital for MNEs and their advisors to conduct TPDD as part of the M&A process to assess the potential transfer pricing risks associated with the transaction.

This article provides practical guidance on best practices for conducting TPDD in M&A transactions to help various heads of finance, tax, and M&A department navigate the complex transfer pricing landscape and achieve successful outcomes.

- **Understand the Business Model through Value Chain Analysis of the Target Company**

A value chain analysis is a critical component of TPDD in M&A transactions. The value chain describes the series of activities a company undertakes to create and deliver its products or services to customers. The analysis involves identifying the various functions, assets, and risks associated with each activity in the value chain and determining how value is added at each stage.

In the context of M&A transactions, value chain analysis is essential for assessing the transfer pricing implications of the transaction. This is because M&A transactions often involve the integration of the value chains of the acquirer and the target company, which can result in changes to the transfer pricing arrangements between related parties.

For example, the acquisition of a target company may lead to changes in the supply chain of the acquirer, which may require a reassessment of the transfer pricing arrangements between related parties. Similarly, acquiring a target company may result in transferring intellectual property rights or other intangible assets, which can significantly impact the future transfer pricing arrangements between the acquirer and the target company.

- **Review of inter-company agreements of the Target Company**

It is crucial to ensure that agreements are in place for inter-company transactions to help MNEs establish the terms and conditions under which intercompany transactions occur. This provides a basis for documenting intercompany transactions, which is essential for transfer pricing compliance and can help to ensure that the necessary documentation is available to support the transfer pricing arrangements. It is important to ensure that these agreements accurately reflect the target company's transfer pricing operations and transactions.

During the review process, it is essential to identify any inconsistencies between the inter-company agreements and the target company's transfer pricing policies and practices.

- **Review of transfer pricing policies and documentation of the Target Company**

The next step is to identify all the inter-company transactions of the Target Company with its related parties and thoroughly examine their transfer pricing practices and policies. Also, verifying that transfer pricing methods applied by the target company are properly documented and commercially justifiable is crucial during the due diligence phase of an M&A transaction. If the target company's transfer pricing policies are not adequately documented or being adhered to, this may indicate a failure to comply with applicable tax laws and regulations. There could be three possible scenarios concerning the maintenance of transfer pricing documentation by the Target Company:

First, the target company has maintained transfer pricing documentation. In this case, the review should focus on the functional and risk analysis; the transfer pricing method used, the selection of the tested party and profit level indicator, and the comparables selected. The importance should also be given to consistencies in applying transfer pricing methods on a year-on-year basis.

Second, the documentation is incomplete, or all the inter-company transactions have not been appropriately covered in the documentation. In this case, the other information substantiating the transfer pricing should be identified, and potential tax exposure and penalties should be assessed.

Lastly, the Target Company has not maintained a transfer pricing documentation itself. In this case, there is a greater likelihood of encountering transfer pricing exposure, necessitating a thorough transfer pricing analysis to evaluate the risks. This analysis would entail identifying intercompany transactions, comprehending the functions carried out and risks assumed by each entity, and benchmarking the transactions against similar businesses. Additionally, the analysis would examine the possibility of penalties due to inadequate documentation and any necessary adjustments.

The review should also consider any adjustments made by the tax authorities in previous audits and the reasons for these adjustments. To cover the potential tax liability arising in the future, the acquirer should get an indemnity from the buyer towards any future payments that may be required to settle the lawsuit. Special consideration should be given to inter-company transactions for which compensation is not provided, e.g., royalty-free licensing arrangement.

- **Ensure the inter-company transactions meet the Economic Substance Doctrine**

The economic substance doctrine requires that a transaction have a meaningful economic impact beyond tax savings and that the taxpayer has a substantial purpose for entering into the transaction other than tax avoidance. This means a transfer pricing transaction must have a business purpose and be commercially reasonable. In other words, the transaction must be structured in a way that would make sense if the parties were unrelated and dealing at arm's length.

If the inter-company transaction fails to meet the economic substance doctrine, the IRS may assert transfer pricing penalties. These penalties can be significant and result in additional tax liabilities and interest, which might impact the purchase price allocation. Therefore, it is essential for the acquirer to conduct a thorough analysis of the target company's transfer pricing practices and ensure that any potential risks are identified and addressed before completing the acquisition.

- **Consider the Impact of Business Restructurings**

Business restructurings can significantly impact the transfer pricing of intercompany transactions. Therefore, it is essential to conduct thorough due diligence to ensure that the deal is structured in a tax-efficient and compliant manner. This includes understanding the changes that have taken place in the corporate structure, how these changes have affected the activities of the related entities, and the business reasons for the restructuring.

When conducting due diligence on a target company's transfer pricing policies and agreements, the acquirer should ask the following questions regarding business restructuring:

- Has the target company undergone any recent business restructuring or reorganization?
- How has the restructuring impacted the target company's transfer pricing policies and agreements with related parties?
- Whether any exit charge paid/required to be paid to the affected entity as a result of business restructuring?
- Are there any outstanding transfer pricing issues or potential tax liabilities resulting from the restructuring that the acquirer should be aware of?

Furthermore, it is essential to consider the options available to Target Company instead of participating in a group restructuring.

- **Assess the Impact of Transfer Pricing Laws and Regulations**

The impact of transfer pricing laws and regulations should be assessed in the TPDD process to determine the potential tax exposure of the transaction. This includes a review of the transfer pricing filing requirements in the jurisdictions where the target company operates and the tax treaties that may apply. The review should also consider the transfer pricing regulations and guidelines issued by the relevant tax authorities, including any recent changes or developments that may impact the transfer pricing policies and documentation of the target company.

Conclusion

The importance of transfer pricing issues is sometimes overlooked during the tax due diligence process. As a result, there may be a risk of insufficient attention being paid to these issues, which can significantly impact the target company's financial and tax liabilities. Therefore, it is important to prioritize transfer pricing due diligence as an integral element of the overall due diligence process in M&A transactions. By doing so, the acquiring company can assess potential transfer pricing risks and develop a plan to manage these risks post-acquisition, ultimately maximizing the benefits of the transaction.

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