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Why Transfer Pricing Matters in Post-Merger Integration and How to Manage Risks Effectively

In a cross-border Merger and Acquisition (M&A) transaction, post-merger integration is one of the biggest challenges companies face. The acquisition of a company brings many questions about compatibility with existing transfer pricing policies and the degree of integration into the acquirer's intercompany charging mechanism. However, the transfer pricing aspects in the context of post-merger integration are often overlooked, and a proactive approach can pay off in the long run.

Our previous article discussed the best transfer pricing due diligence practices in international mergers and acquisitions. This article will delve into the various transfer pricing aspects that should be carefully considered during post-merger integration. We will examine the potential risks and benefits of addressing transfer pricing early in the integration process, covering aspects ranging from internal restructuring to process integration. Taking proactive measures to manage transfer pricing can help companies mitigate tax and transfer pricing risks, avoid operational challenges of restructuring, and fulfill their legal obligations.

Let's analyze transfer pricing issues during post-merger integration using the following example.

XYZ Inc ("US Co" or "the Company") is a multinational company based in the US that provides technology solutions to businesses worldwide. The company has recently acquired ABC Ltd, a technology company based in Europe. The acquisition has been completed, and now the companies are in the process of integrating their operations. However, there are several transfer pricing challenges that the company is facing during this process.

Following are the transfer pricing considerations that multinational companies need to keep in mind during post-merger integration:

Deciding the Structure of the Group

Deciding on the group's structure is a crucial aspect of post-merger integration, as it can significantly impact the integrated group's tax liabilities. This involves determining how the various entities within the newly merged group will be organized and how they will interact with each other for transfer pricing purposes. This also involves deciding whether to establish a distinct subgroup for the business model of the acquired entity or to merge it with the existing operations of the acquiring entity.

Example:

One of the primary challenges that US Co may face is deciding on the structure of the merged group. The company needs to determine how it will integrate the operations of ABC Ltd into its existing structure.

In addition to these considerations, it's essential to consider the group's supply chain and how it will be affected by the post-merger integration. Proper planning and execution of the group structure can help companies realize tax efficiencies and avoid disputes with tax authorities. As the group structure can significantly impact the allocation of profits and costs between group entities, it's crucial to ensure that the group structure reflects the economic reality of the business and is aligned with the arm's length principle.

- **Internal Restructuring**

Internal restructuring is a significant aspect of post-merger integration from a transfer pricing perspective. By merging two or more companies, the existing group structure may become complex and redundant, and entities may be realigned to ensure that the integrated group is functioning optimally.

The restructuring may involve changing the functions and reallocating commercial risks of the entities involved in the transaction, transferring intangible property, reorganizing key managerial personnel, etc.

Example:

US Co may transfer some of the functions and reallocate commercial risks from one group entity to another to ensure that they are being used in the most tax-efficient manner for the integrated group, or US Co may centralize some of the functions, such as procurement, sales and marketing, operations, etc. to improve efficiency and cost savings.

Let's consider another example where research and development (R&D) activities have now been transferred to another subsidiary of US Co in India that used to be performed by ABC Ltd. As part of this transfer, ABC Ltd also transferred its patents, technologies, processes, and know-how to US Co. Additionally, some employees of ABC Ltd have also been relocated to India to help start the R&D activities. This may be considered as transfer of ongoing concern and the same may require adequate compensation and/or exit charge.

Therefore, it is crucial to evaluate the transfer pricing implications of the restructuring and decide whether there is any exit charge or reallocation of profits is required, as it can significantly impact the tax position of the integrated group. Valuing intangibles and allocating profits and costs between group entities must be done correctly to avoid tax issues such as underpayment of taxes in one jurisdiction or double taxation. Moving employees, technology, and other assets across borders can have significant transfer pricing implications. Ensuring these assets are transferred at arm's length and in compliance with local tax laws and regulations is crucial.

To ensure a smooth transition, companies must address these transfer pricing implications early in the post-merger integration process. In addition, proper planning and execution of internal restructuring can help companies realize potential tax efficiencies and avoid transfer pricing disputes with tax authorities.

- **Transfer of Intangible Property**

As part of a merger or acquisition, when intangible property (IP) is transferred from one entity to another entity, it can significantly affect transfer pricing as the valuation of the IP can substantially impact the profits of both entities involved. To determine an arm's length price for the transfer of IP, both the transferor's and transferee's perspectives must be considered. MNEs should ensure that the valuation of the IP is conducted using an appropriate valuation methodology and that the price paid for the IP is consistent with market rates.

MNEs should also consider each entity's contributions to the IP's development, enhancement, maintenance, protection, and exploitation (DEMPE). Failure to allocate profits correctly can result in transfer pricing issues, potentially leading to tax disputes and penalties. In addition, there has to be economic substance in the transfer of IP from one entity to another entity of the group. In other words, the transfer should be driven by genuine business reasons, such as improving efficiency, expanding markets, or generating profits, rather than just tax savings. This is important because tax authorities may challenge transactions that lack economic substance and re-characterize them as tax-avoidance schemes.

Example:

US Co acquired the worldwide rights of the IPs owned by ABC Ltd. In this case, US Co should compensate ABC Ltd an arm's length compensation for transferring such IP. Additionally, US Co should ensure that the transfer of IP is done in a way that reflects the economic reality of the transaction and is consistent with the arm's length principle, which requires that transactions between related parties be conducted as if they were between unrelated parties under similar circumstances.

- **Aligning Transfer Pricing Policies:**

Companies involved in a merger or acquisition may have different transfer pricing policies and practices. Harmonizing these policies and practices across the group can be a significant challenge, as it involves aligning transfer pricing methodologies, benchmarking practices, and documentation requirements.

Example:

US Co and ABC Ltd may have different methods for determining transfer prices or approaches to allocating costs and profits. Therefore, the company must align these policies to ensure consistency across the group.

The first step in aligning transfer pricing policies is to identify and evaluate the existing policies of each entity. This involves assessing the transfer pricing methods and determining their appropriateness for the new group structure. It is also important to ensure that the transfer pricing policies align with the merged entity's business strategy and accurately reflect each entity's functions, risks, and assets.

Once the existing policies have been evaluated, the merged entity can develop a new transfer pricing policy that aligns with the business strategy and meets regulatory requirements. The policy should address the allocation of profits and costs between related parties, the transfer pricing method used, and the documentation required to support the policy.

It is also important to communicate the new transfer pricing policy to relevant stakeholders, including senior management and heads of various departments, including finance, tax, legal, operations, etc. This ensures that everyone knows the new policy and understands their roles and responsibilities in implementing it.

- **Revising Transfer Pricing Agreements:**

Revising existing transfer pricing agreements to reflect the new group structure and operations may be necessary. The transfer pricing agreements may need to be updated to reflect any changes in the allocation of functions, risks, and assets among the group entities.

It may also be necessary to review the terms of the agreements to ensure they continue to meet the arm's length principle and any applicable tax laws and regulations. This may involve determining whether the current pricing arrangements are still appropriate or need to be adjusted based on the new post-merger realities.

Example:

US Co moved R&D functions from ABC Ltd to one of its subsidiaries in India. As a result, the functional profile of ABC Ltd has changed. This requires different pricing arrangements than were previously in place. The inter-company agreements should reflect this new pricing arrangement and contract terms.

Moreover, entering into new transfer pricing agreements may be necessary. For instance, if the merged entity begins to engage in new types of transactions not previously contemplated in the transfer pricing agreements, new agreements may be necessary to ensure compliance with the arm's length principle and applicable tax law

- **Integration of Different Accounting Systems:**

Companies involved in a merger or acquisition may have different accounting systems and processes, making it challenging to integrate their financial data. This can make it difficult to accurately identify and track intercompany transactions and ensure that transfer pricing policies are applied consistently across the group.

To address this issue, companies should evaluate their accounting systems and determine how they can be integrated to create a unified system. This may involve selecting one system to be used across the merged entity or developing a new system that incorporates the best practices from both companies.

- **Communication and Coordination:**

In the context of transfer pricing, effective communication and coordination between different departments within the merged company is crucial to ensure that the transfer pricing policies and procedures are properly implemented and adhered to.

During post-merger integration, it is essential to establish clear lines of communication between the tax, finance, and accounting teams to ensure that the transfer pricing policies are aligned with the business objectives and adequately documented. This includes developing a timely and accurate transfer pricing documentation process and communicating changes in transfer pricing policies and procedures to all relevant stakeholders.

Conclusion

Transfer pricing plays a critical role in post-M&A integration for multinational entities. It is essential to have a comprehensive transfer pricing strategy that aligns with the business objectives of the merged entity. Proper planning and documentation of transfer pricing policies can help avoid potential tax disputes and penalties. Ultimately, a well-designed transfer pricing strategy can contribute to the success of post-M&A integration by promoting transparency, consistency, and fairness in intercompany transactions. Multinational entities should seek the advice of transfer pricing experts to navigate the complexities of post-M&A integration and to develop a transfer pricing strategy that meets their unique business needs.

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