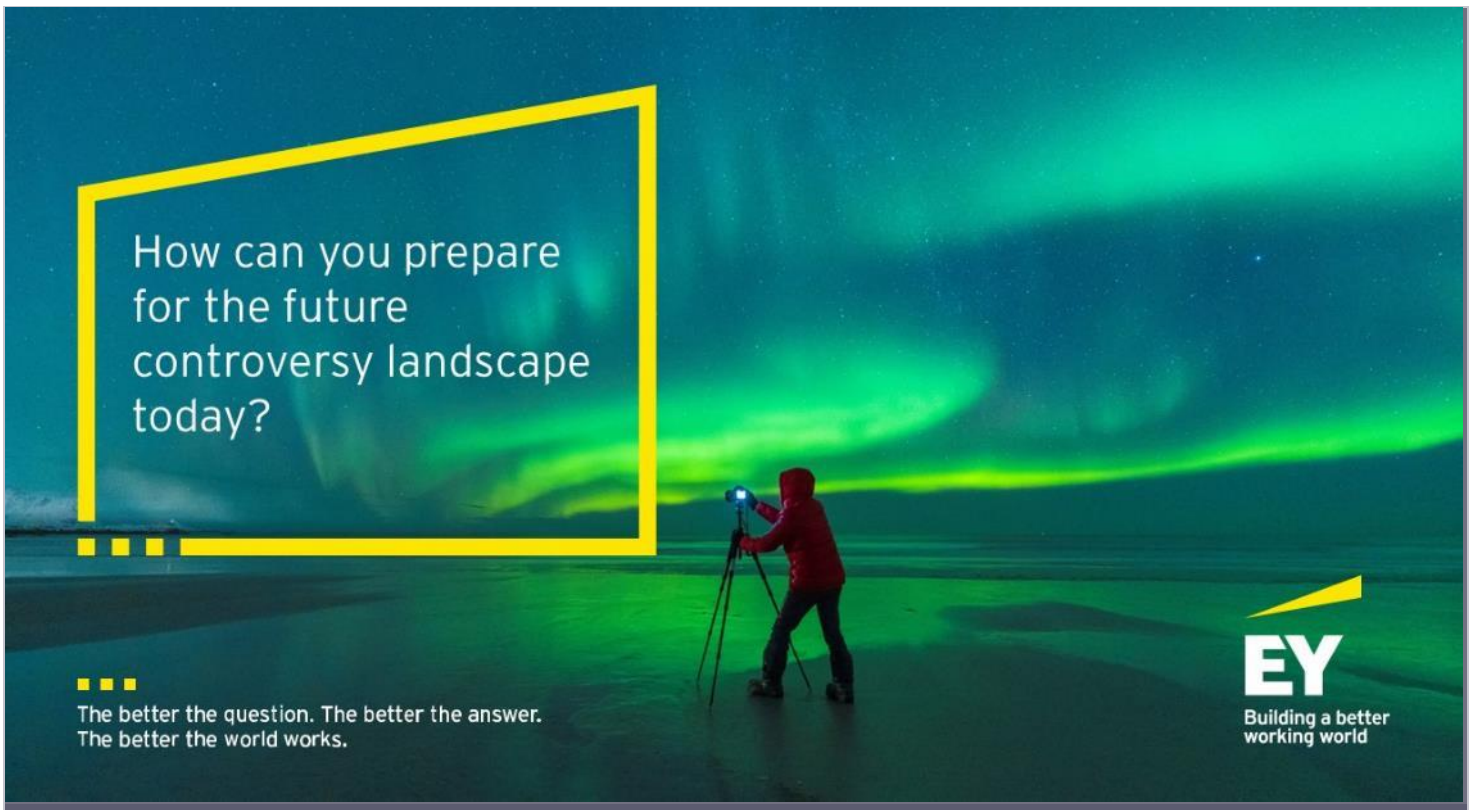

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Improve risk management by understanding the interplay between transfer pricing and indirect taxes

Transfer pricing and indirect taxation are both hot topics for multinationals, and the two areas interact in many ways. Understanding the interplay between transfer pricing and indirect taxes can help multinationals identify deductions and manage additional taxes and penalties. And while both tax types aim to apply an "arm's length" standard to related-party transactions, it's important that multinationals understand the fundamental differences that can increase audit risk.

One key risk area stems from a timing mismatch. Indirect taxes, such as customs and excise duties and value-added tax (VAT), are levied around the time when a transaction or importation takes place, whereas transfer prices may be set retrospectively. Transfer pricing adjustments made after goods have been imported or sold may create an issue for the duties and VAT that have already been declared and paid. If the transfer price increases, the value for indirect taxation may have been understated — leading to additional taxes and penalties. But if the price decreases, companies may struggle to reclaim the additional tax and duty paid. No wonder this is a growing area for audit scrutiny and taxpayer disputes.

Differences in import valuation methodologies are another risk area. Customs authorities are routinely looking to companies' transfer pricing documentation to verify arm's length import values during post-entry audits. This approach, however, may not account for the differences in valuation methodologies. Imported goods are valued individually on a transaction-by-transaction basis. In contrast, transfer pricing studies may take a broader category-by-category approach — making it hard to make a true comparison.

Multinationals need to recognize the interplay between transfer pricing and indirect taxes, confirm that their policies align, and document and understand any different valuation approaches. By addressing the connection between indirect taxes and transfer pricing proactively, multinationals can establish effective tax approaches and procedures that anticipate and address issues.

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