Alvarez & Marsal TAX U.K. – Why Should You Consider Transfer Pricing When Making Business Acquisitions?

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As part of our series on transfer pricing and its key areas, this article will discuss its importance for companies making business acquisitions, be they of other companies or trade and assets.

Our last article covered the transfer pricing considerations of international expansion, but one important expansion scenario to examine is the acquisition of businesses. In doing so, companies can broaden presence in new markets, drive synergies, acquire intellectual property, amass a specific type of skilled workforce, establish a customer base or set up certain operations — such as manufacturing, service centres or back office functions — in lower cost countries. There will often be a wide variety of associated transfer pricing considerations, which include the pricing of post-acquisition-related party transactions, that impact these transactions that must be considered in more detail before, during and after the acquisition process.

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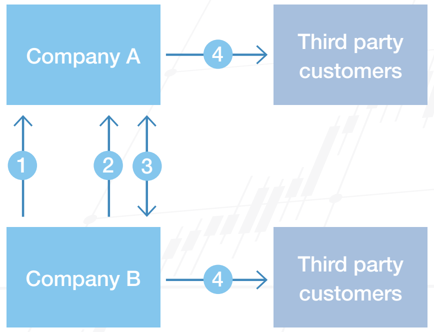
TRANSFER PRICING CONSIDERATIONS FOR ACQUISITION SCENARIOS

Inorganic growth, especially international expansion, brings with it a plethora of tax- and transfer pricing-related considerations. One example of the transfer pricing aspects commonly faced by growing businesses is highlighted in the following scenarios:

1. ONE-OFF POST-ACQUISITION TRANSACTIONS

In this simplified example, the software business Company A in country A may acquire Company B in country B; both companies own valuable software-related intellectual property (IP) and both provide software subscriptions and related services (SaaS) to their worldwide customers.

It may be that, following the acquisition, Company A wishes to acquire the software IP owned by Company B. There may be certain options for doing this, which are depicted in the diagram below:



1 Option 1 – Transfer of IP

2 Option 2 – Declining IP license

3 Option 3 – Development cost sharing arrangement or split of profits

4 SaaS

- Under Option 1, Company B may sell the software IP to Company A and then license this back on an arm's length basis, that is, on the same terms as a comparable transaction between independent entities both acting in their own self-interest. This would mean that the initial sale of the IP would also often need to take place on an arm's length basis, requiring a transfer pricing valuation to be carried out as part of the software IP sale.
- In Option 2, Company B may license the software to Company A in return for royalties that may decline over an appropriate period of time representing the useful life of the IP. At the end of this period, Company A may acquire the IP for any remaining value.
- Through Option 3, Companies A and B may decide to combine their development efforts to create a new software IP while potentially keeping their respective legacy IP products in the market. In such a case, the companies may agree to share the development costs or resulting profits from the commercialisation of the new IP in line with their contributions to its development.

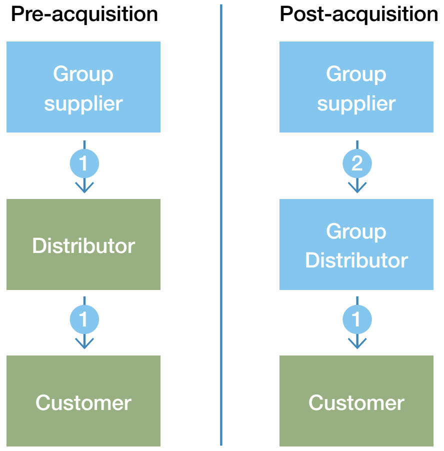
Option 1 may result in an instant exit charge on the transfer of the IP, whilst option 2 may spread such a charge over a period of time. Depending on the circumstances, option 3 may result in either of the above.

The remaining transactions may include the licence of IP by Company A and the provision of services —such as management services, professional services and more— between the parties.

The most appropriate option would be that which is best for the business, but regardless of the option selected, careful consideration should be given to the substance and location of software IP-related development functions, including the location of senior development staff. For example, the company employing these people and where they are physically based will, in turn, drive the range of arm's length pricing outcomes.

2. RELATED-PARTY TRANSACTIONS BETWEEN "LEGACY" GROUPS AND ACQUIRED COMPANIES

A business acquiring a foreign entity should consider how that entity fits within the existing, or newly formed, intra-group transfer pricing framework. The diagram below outlines a simplified example of such a situation — the acquisition of a third-party distributor that previously acted for the acquiring company in a particular territory:



1 Sale of goods

2 Intercompany sale of goods

The new intercompany transaction between the "legacy" supplier and a new related-party distributor is subject to transfer pricing rules, which require all intercompany transactions to be conducted at arm's length. As such, while it may appear that the distributor's operational profile remained largely unchanged following the acquisition — including the buying of products from the now related supplier and resale in the local market — key aspects of this new intercompany transaction, such as the allocation of risks, may be materially different. For example, the distributor is required to adhere to a group-wide price list and is limited in the discounts that may be extended to its clients. In such situations, such factors may need to be taken into account when goods are priced.

As local tax authorities will often treat the pre-acquisition pricing arrangement as a point of reference, the newly formed group is advised to substantiate the post-acqui sition pricing by carrying out a transfer pricing analysis.

Naturally, if the acquired company or group has more complex operations, such as owning IP or cross-selling products to "legacy" group entities, then the transfer pricing setup becomes even more crucial and should be analysed in depth to assure that the combined group is compliant in each territory in which it operates.

3. ACQUISITION OF TRADE AND ASSETS

Where the acquisition relates to trade and assets, it may often be necessary to consider their arm's length value following the acquisition, especially when all or part of the trade or assets are transferred out into other countries. It should be noted that a post-acquisition Purchase Price Allocation may not be deemed acceptable from a tax perspective.

Several transfer pricing considerations apply to the above scenario and span all of the examples herein, including the example in our December issue that examines international expansion.

4. RELATED-PARTY TRANSACTIONS WHERE A GROUP OF COMPANIES IS ACQUIRED

If a group of companies is acquired, then it will be necessary to consider and validate the arm's length nature of the existing transactions between them, considering any new transactions that may take place post-acquisition either within the group acquired or with the acquiring group of companies.

The transfer pricing considerations of such a transaction are likely to span all of the examples herein, including the example in our December issue that looks at international expansion.

CONCLUSION

Transfer pricing considerations are a core issue for any acquisition, but they are especially important in international transactions or where IP or groups of companies are concerned. Companies need to be prepared for the potential considerations that may arise during and after an acquisition to ensure compliance and identify the best path forward.

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