Development of sustainable transfer pricing policies through effective organization of the tax function

Transfer pricing is a major concern for multinational enterprises. On the management side, well managed transfer prices enable a correct allocation of resources within the company. Optimal management of transfer prices further involves: (i) securing risks associated with tax reassessments and (ii) benefiting from the opportunities that suitable transfer price policy may enable. In most cases, the tax department is responsible for tax management of transfer prices. This article aims to show how an effective tax department (first section) enables setting up an efficient transfer pricing policy (second section).

1. An effective tax department

1.1. Objectives

The objectives of the tax department are to manage tax risks and to manage the group's overall tax charge. A balanced mission statement will mention the tax department's role as a support to the business operations of the group.

Setting up an effective tax department requires sharing objectives with and obtaining consensus between the tax function's "service delivery team" and its "customers." This involves agreeing on the definition of procedures, ensuring that these procedures are being applied, and agreeing on the tax department's performance measurement.

The service delivery team of the tax department includes the tax specialists themselves as identified in the organization, the consolidation accounting team (who are information providers), and the "hidden tax function" that deals with tax matters (accounting teams in subsidiaries, strategic development teams, etc…). Customers include Corporate Management, head office and subsidiary finance departments, business unit management…

The tax function can be effective only if it relies on a consensus between the delivery team and the customers of the tax department. It is essential to realize that the set up of such an organization will affect the behavior of both the delivery team and the customers of the tax department. Then, tax matters are no longer the sole concern of tax experts standing alone detached from business but are the responsibility of all interested parties so that the corporate culture includes a tax perspective. This incorporation of a tax perspective is a vital condition to defining and implementing a transfer pricing policy that corresponds to the tax objectives of the group.

1.2. Stages of the set up of an effective tax department

Setting up an effective tax department involves several stages. The outcome of each stage requires a consensus between the tax department's service delivery team and its customers.

1.2.1. Preliminary stage – Steering Committee

The preliminary stage consists in setting up a steering committee which will will be chaired by the ultimate responsible, the CFO and will include representatives of the tax department's service delivery team and its customers. The steering committee's role is to act as a consensus tool. It is responsible for evaluating the efficiency of the tax department.

Members of the steering committee should include the head of tax, the head of consolidation, an external consultant and, representing the tax department's customers, a panel of representative managers (head of Business Units, head of development…). The selection of the steering committee is an essential stage. The tasks of the steering committee notably include the definition of the interview process required as part of the definition of the tax department and of the selection of relevant interviewees. The steering committee also validates the findings of each stage.

1.2.2. First stage – Validation of the needs and objectives of the tax department

Interviews enable the identification of:

- Needs and objectives of the tax department as defined by the tax department's service delivery team (tax specialists, consodilation teams, hidden tax function…)
- Needs and objectives of the tax department as defined by its customers (Corporate management, head office finance department and subsidiaries finance department, business units management…)

These interviews enable completion of a diagnostic. The diagnostic includes a design of the boundaries of the "Minimal Tax Function," which is reviewed by the steering committee. The Minimal Tax Function varies depending on the corporate culture. It corresponds to the minimum the tax department's customers expect and the maximum the tax department's service delivery team can provide given its resource and budget allocation.

1.2.3. Second stage – Defining the objectives of the tax department

This stage's main objective is to define the tax department priorities. These priorities should themselves depend on the level of tax maturity and tax management of the group and its (foreign) subsidiaries.

The objectives of the tax department may then be formalized in a "quality charter" provided to the tax department's service delivery team and its customers. This charter is signed by the head of tax and the finance director, approved by the steering committee.

The "quality charter" describes the objectives of the tax department which result from the consensus approved by the steering committee, its organisation (centralized or decentralized…), its operations (rights and obligations). The second part of this article will focus on the transfer pricing objectives of the tax department. The quality charter is part of a continuing quality improvement process where performance is measured on the basis of the objectives of the tax department and the satisfaction of its customers. In this respect, given its nature, transfer pricing probably offers the most obvious link between the tax department and its customers. As an example, transfer pricing policy may directly impact the performance measurement of the subsidiaries.

A procedures manual completes the quality charter. The procedures manual includes the objectives of the tax department, formalizes the priorities defined by the steering committee and takes into account the subsidiaries' tax maturity and tax management capabilities.

The procedures manual may differ depending on whether we consider the head office tax department or a subsidiaries tax function (which may or may not include a tax specialist).

The procedure manual relies on four cornerstones:

1- Risk management

This objective includes:

- Organizing tax risk prevention. As an example, the tax department will assist in setting up risk management and prevention procedures within the subsidiaries/countries. Its role will also include performing audits to assure compliance with these procedures and harmonizing procedures within the group (notably in respect of the transfer pricing policy).
- Identifying key areas of risks. For example, a subsidiary/country tax department's responsibilities may include identifying risks with the accounting teams, audit teams and external auditors. Its responsibilities would also include quantification of those risks and feeding the reporting tools.
- Controling/mastering risk management – as an example, the head office tax department advises the head office finance department on the amount of tax provision to be booked in the consolidated accounts.

2- Optimize the group's tax charge

This objective includes:

- Determining current tax rates in statutory accounts;
- Determining the consolidated effective and deferred tax rates; and
- Defining indicators as regards taxes that are not corporate income based.

It is essential to understand these different parameters in order to implement and manage an optimal transfer pricing policy. Doing so requires being in a position to perform simulations on the effective tax rates.

3- Organize tax knowledge sharing

This objective includes:

- Training of the tax teams in the various countries depending upon the subsidiaries' tax maturity and tax management. In this respect, the tax department plays an important educational role with regards to transfer pricing for the group's business people. This role goes well beyond the mere preparation and circulation of procedures and documentation, but includes frequent meetings and discussion to inform the group's business people of the issues at stake, the constraints and the risks associated with tax matters in general and with transfer pricing in particular.
- Brainstorming within the tax department to enable the identification of tax optimization strategies.
- Tax show how, which involves reporting on the performance of the tax department to both the tax department' s service delivery team and its customers.

The involvement of business people and operational teams in the definition of a transfer pricing policy should encourage the development of a tax awareness within the group. Similarly, it also encourages the grounding of the tax policies in business concepts. This is particularly important as in respect of the transfer pricing policy.

4- Performance measurement

Performance measurement should be based on the following four criteria:

- Risk management - This may consist in an annual audit of the procedures to assess compliance with those procedures and if need be the design and implementation of corrective measures
- The impact of tax matters on the financial performance of the group
- Tax customer satisfaction
- Knowledge sharing

1.2.4. Third stage – Define a communication tool

This stage involves setting up a communication tool between the group and its subsidiairies, in order to control risks, to manage the effective tax rate and to follow up on taxes not based on corporate income.

Depending upon the management and tax objectives of the group, the communication tool may be an autonomous IT tool designed for the use of the tax department or an IT tool that supplement the consolidated reporting with a number of alternatives.

In this later case, tax reporting will be linked to the consolidated reporting and should enable an automatic link between current taxes and deferred taxes. The communication tool should enable to simulate the financial impact of a tax optimization strategy. This tool should therefore notably enable assessing the impact of a change in transfer pricing policy.

Regardless of the tool, it should enable to provide information to the tax department on the provision in the accounts in terms of tax risks, on the effective tax rates and enable to follow up on taxes that are not calculated in corporate income.

1.2.5. Fourth stage – Testing the communication tool

This stage enables to test, based on a representative sample of subsidiaries, the functioning of the tool and assess whether modifications are required. The test involves a representative sample of subsidiaries. Subsidiaries are selected to reflect various levels of maturity and the presence (or not) of an in-house tax specialist. Selected subsidiaries should also be involved in significant intra-group relationships (products and services, intangibles, financing) so that it is possible to test the impact of a change in transfer pricing policy.

The objective is to test whether the instructions contained in the manual for feeding the tax reporting are relevant and to measure the time required to treat tax related information. At the end of this stage, it may be necessary to reshape the reporting tool.

1.2.6. Fifth stage – IT specifications

This stage involves setting up IT specifications in order for the IT teams to be in a position to adapt existing software to the specifications.

The tax department is then in a position to obtain the necessary information in order to assess tax risks. The tax department relies on IT tools enabling to control the tax charge of the group through the effective tax rates and indicators on other taxes.

2. Definition and implementation of a transfer pricing policy

2.1. Objectives

The implementation of a transfer pricing policy should take into account the corporate culture and the organization of the tax function within the group. Implementing or redefining a transfer pricing policy will first require the tax function to be properly organized.

The implementation of a transfer pricing policy can not be effective unless there are procedures available to control the risks and the global tax charge of the group through indicators such as the local, global and consolidated effective tax rates.

The transfer pricing policy directly impacts income recognition in each jurisdiction and risks related thereto (therefore the global tax charge). The transfer pricing policy may also impact performance measurement mechanisms within the group. Transfer pricing includes both operational and tax considerations.

Business teams rely in the course of their day to day business on pre-defined transfer prices as part of their intra-group transactions. One of their main concerns is to be in position to have at their disposals a set of clearly defined rules which can be used to set the terms and conditions of their intra-group transactions.

As regards the definition of a transfer pricing policy, the objectives of the tax department are identical to its overall objectives: control/master the tax risks and the effective tax rate. In addition, management will also require that terms and conditions of intra-group transactions are consistent with the strategic objectives of the group.

Finally, recent modifications in terms of accounting norms also require increased transparency. In some countries, auditors are required to attest that transfer pricing documentation is in place.

2.2. The process of implementing an efficient transfer pricing policy

Implementing a transfer pricing policy involves five key stages, which are described below.

2.2.1. Stage one – Data and information gathering

The objective of this stage is to collect data and information on the activities, functions, risks, and assets of the transacting entities as well as the financial data required as part of the analysis. This stage involves completing:

- A value chain analysis of the industry and of the group, the objective of which is to determine the key value drivers in the business.
- A functions, risks and assets analysis grid (enabling to perform a functional mapping of the group)
- Intra-group transactions flows (including the amounts at stake)
- The most important items of relevant segmented profit and loss statements for the key activities of the group
- The contractual arrangements relating to the intra-group flows

Information required are generally obtained through (i) interviews with relevant managers (from businesses and from the finance departments) and (ii) information technology systems (databases…) which enable the identification of relevant financial data. The minimal output of this stage should be a mapping of intra-group flows.

2.2.2. Stage two - Diagnostic

This analytical stage relies on the use of information gathered through the first stage. The objective of this stage is to define assess what constitutes an arm's length paradigm for the group. This stage requires putting into perspective the value chain analysis, the nature (and significance) of intra-group relationship, the remunerations of functions, risks and assets and the consequences of these factors on actual remuneration of the related parties. The output of this phase is a quantification of the main tax risks and the identification of areas where planning opportunities are possible. We note in this respect that a comprehensive understanding of the value creation is essential. Transfer pricing policy can not be inconsistent with the value chain analysis. In addition, this stage also requires the use of standard transfer pricing tools: functional, risks and assets analysis, and the economic analysis enabling to determine arm's length conditions.

If a transfer pricing policy is already in place, the group should be in a position at the end of this phase to define key areas of risks and to identify opportunities. The conclusion of this stage includes proposals for modifying, amending and/or redefining the transfer pricing policy. The presentation of alternative policies encourages discussions and therefore facilitates the decision process. A radical change in policy may reduce tax charge risks whilst enabling a better control of the risks (or vice versa) but be difficult to implement. On the contrary, a mere evolution in current transfer pricing policy may be relatively easy to implement but its impact on tax charge and tax risks could be minimal or even negative.

In the absence of transfer pricing policy, the main objective of the diagnostic is to propose various transfer pricing policies. The conclusion of this stage should also be the presentation of the basic design of different transfer pricing policies. Each proposal should include pros and cons in order to facilitate decision making.

2.2.3. Stage three – Decision process – Design of a transfer pricing policy

Issues with the current transfer pricing policy have been identified through the diagnostic and should provide managers with the necessary information to take an informed decision.

The transfer pricing policy will rely on the value chain analysis, the functioning of the group and of the subsidiaries or entities, the functional, risks and assets analysis, and the economic analysis. Based on the above, the group is in a position to define a consistent transfer pricing policy, coherent with the functioning of the group, management objectives and the arm's length principle. Ultimately, this phase will conclude in a test of the basic design of the model enabling to assess its impact on current and consolidated effective tax rates.

2.2.4. Stage four - Implementation

Once the transfer pricing policy is defined, it then needs to operate properly within the group. In order for a transfer pricing policy to work properly, it needs to be understood, accepted and applied by all relevant parties. Implementation therefore requires that responsibilities have been clearly defined. Implementation of the transfer pricing policy will rely on a pertinent economic analysis, validated by the operations and consistent with the tax risks and tax charge objectives of the group.

This stage is undoubtedly the most important of the five phases. An improperly implemented arm's length transfer pricing policy is unlikely to be arm's length and is inherently risky. When an arm's length transfer pricing policy has been defined, transfer pricing risk is simply an implementation issue. Defining an organization, procedures and information systems as described in the first phase of the study is the minimal investment required in order to implement a tax efficient transfer pricing policy.

2.2.5. Stage five - Documentation

Transfer pricing documentation, which combines the stages required to define the transfer pricing policy is one of the key aspects of the management of intra-group relationships. This documentation also includes contractual documentation (agreements…). Transfer pricing documentation is first and foremost an external communication tool which may be provided to relevant tax authorities, and an internal communication tool (since the documentation should be made available to the relevant parties involved within the group).

Transfer pricing documentation does not only involve the formalization of the above mentioned stages. Transfer pricing documentation should also include a value chain analysis of the industry and the group (the objective of these analyses is notably to characterize key value drivers), a functional, risks and assets analysis, and the economic analyses.

This tool should be regularly updated in order to take into account changes within the group and evolutions in legal requirements. Best practice requires built-in signaling of needs for maintenance and repair of the transfer pricing system and its documentation.

The above five stages should not be viewed as one shots stages. Managing transfer price is a continuous and dynamic process.

2.3. Typical organizational profiles and transfer pricing management: Two examples

Transfer pricing responsibilities can be organized in different ways. In order to simplify, we distinguish two scenarios: decentralized transfer pricing management, mostly managed by operational teams (e.g., transfer pricing policy for a business unit is the responsibility of that business unit) on one hand, and centralized on the other hand (e.g., the transfer pricing policy is the responsibility of head office). These two organizational models are theoretical structures. The organizational profile of most multinational enterprises is likely to be a combination of characteristics from both profiles.

Regardless of the organization, the tax department remains a key player in the transfer pricing policy. This section describes what could be its roles and its responsibilities in each of those organizational models.

2.3.1. Decentralized model

Key characteristics of this organization are that decision power is delegated outside the headquarters (e.g., in terms of geography).

In this organization, operations and their finance teams are responsible for managing the transfer pricing policy as well as ensuring that implementation complies with existing regulations.

In spite of the decentralized nature of the organization, the head office tax department is strongly involved in transfer pricing decisions. In fact, the tax department is the internal advisor on transfer pricing policy and matters. In this respect, it should have at least a veto right on all transfer pricing policy related decisions (for example, when a change in policy yields non quantifiable risks).

Responsibilities are therefore shared between various actors depending upon the structure of the group. Whilst operations are responsible for diagnostic, definition and implementation of a transfer pricing policy, the tax department provides an advisory role and must be systematically involved with any transfer pricing related matter in order to ensure that the policies comply with the overall tax objectives of the group and that the transfer pricing policies are coherent. In general, adequate implementation of this model is difficult unless there is a very high degree of transfer pricing and tax knowledge at the operational level within the group. In particular, efficient implementation of this model necessitates well a structured tax training organization and sufficient time and resources available within the tax department to regularly perform and update tax and transfer pricing training to the operations. Tax risk management and tax knowledge sharing processes within the group, discussed in the first part of this article, need to be of the highest standards in order for this organizational model to work.

The main advantage of this organizational model is that it encourages appropriation of the transfer pricing process by operations, which are also the main source of information required to define and implement the policy. However, as mentioned above, efficient implementation requires a strong tax discipline within the group and a comprehensive diffusion of transfer pricing and tax knowledge within operations.

The main risk with this model is that the transfer pricing policies are not well coordinated and that there is no coherence in their set up rendering the implementation on a group-wide basis, of tax efficient transfer pricing policies difficult. As a corollary, unless operations have sufficient knowledge and understanding of tax and transfer pricing, it may be difficult to efficiently monitor tax and transfer pricing risks.

In conclusion, whilst this organizational model suits naturally decentralized multinationals such as groups which have resulted from acquisitions in various industrial sectors where there are limited intra-group transactions between different sectors, the role of the tax department must not be downplayed under such an organization, notably with regards to its training and risk management objectives.

2.3.2. Centralized model

2.3.2.1. **Positioning of the transfer pricing team**

Under a centralized organization of transfer prices, the tax department is responsible for the management of the transfer pricing policy. In this model, the transfer pricing team, which may include members of the tax department as well as controllers and other finance specialists, is the main force in structuring and managing transfer prices. Its implication is therefore strong in each of the five stages described above. In this organizational model, the transfer pricing team will, in general, be reporting to the tax director. However, this is not always necessary; one can imagine situations where the transfer pricing team reports directly to the CFO.

The next two sub-sections discuss the responsibilities of the transfer pricing team in respect of (i) managing tax risks, and (ii) managing the global tax charge of the group.

2.3.2.2. Transfer pricing team and management of the group's tax charge

The role of the transfer pricing team is to propose solutions in respect of the global tax charge. These propositions are provided and reviewed by operations management and the group's head office management. Analytical stages required as part of any transfer pricing planning exercise (data and information gathering and diagnostic) are the responsibility of the transfer pricing team. Analytical work will rely on resources of other departments of the group (e.g., strategic management, finance team, sales team…) as well as with external advisors (unless the transfer pricing team has very large resources).

Then, the transfer pricing team will participate to discussions regarding the selection of a transfer pricing policy. Its minimum involvement is that of an internal advisor, the approval of which will be systematically required for all key decisions. Finally, the transfer pricing team will also be in charge of implementing the transfer pricing policy. This task is likely to involve setting up procedures and organizing the relevant information flows.

The transfer pricing team will rely on existing reporting tools so that it can propose tax optimal transfer pricing policies after having simulated their impact.

2.3.2.3. Transfer pricing team and tax risk management

The occurrence of a transfer pricing related tax risk may have two causes: an ill-conceived transfer pricing policy (the design of which is inconsistent with the arm's length principle – design risk) and/or an improperly implemented transfer pricing policy (implementation risk). The involvement of the transfer pricing team in the definition of the policy should minimize the first category of risks. This sub-section therefore concentrates on implementation risks.

In a centralized model, responsibility for implementing the transfer pricing policy belongs to business teams. Business teams, through their daily activities, are effectively implementing the policy. The role of the transfer pricing team is to determine appropriate procedures to manage and follow transfer pricing related tax risks. Reporting tools described in the first section of this article are particularly adapted to identify rapidly and precisely potential risks.

The transfer pricing team is responsible for tax compliance aspects (e.g., preparing transfer pricing documentation in countries where documentation is required). This does not however mean that the transfer pricing team manages all transfer pricing related issues. As an example, it is rarely possible that a transfer pricing team completes transfer pricing documentation on a group wide basis.

Therefore, the transfer pricing team will need to rely on internal or external resources. Transfer pricing documentation, intra-group agreements and important decisions regarding transfer prices will systematically require its involvement and its approval.

Finally, the transfer pricing team will also be responsible for defining the defense strategy in a tax audit, and will be involved in managing the tax audit. Its involvement could for example necessitate the review (or the drafting) of any communication with the tax authorities. A member of the team will participate to key meetings with the tax authorities. Similarly, the transfer pricing team will propose agreements with the tax authorities, with the approval of relevant operations and finance teams. Management of the agreements with the tax authorities (e.g., advance pricing arrangement) will also be the responsibility of the transfer pricing team.

One of the advantage of this type of organizational model is that it is particularly adapted to multinational enterprises where head office has a role that goes well beyond coordination of various activities and where intra-group transactions are significant (e.g., where intra-group sales are a significant proportion of total sales). This organizational model also facilitates implementation of tax efficient transfer pricing policies. It may be worth ensuring that this organization does not lead to the implementation of purely tax driven transfer pricing policies which would not be consistent with the group's value creation process. Interactions between business teams and the tax department are essential in order to ensure that the transfer pricing policy is grounded in business concepts.

2.4. Conclusion

For multinational enterprises, managing transfer prices requires both the ability to implement a sustainable transfer pricing policy that satisfies the arm's length standard and to ensure that the policy is adequately implemented. Defining precisely the responsibilities in terms of transfer prices within the tax department and within the group is critical in order to manage these issues successfully. Implementation of an effective tax department is an essential pre-requisite to the definition of a tax efficient transfer pricing policy.