Operational Transfer Pricing: Practical Applications

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What is operational transfer pricing?

Ask ten different transfer pricing directors to define operational transfer pricing and it is likely that you will get ten different answers. At its simplest, operational transfer pricing can mean period-end adjustments to ensure that members of the controlled group achieve intercompany pricing targets. At its most complex, operational transfer pricing can be defined as the integration of the transfer pricing process throughout the organization. This suggests processes such as the formation of best practices, policies and procedures; interfacing with the finance department to generate customized reports specific to transfer pricing; active intercompany price setting and adjusting, interim monitoring and year-end adjustments; as well as document maintenance and retention. The reality is that most companies fall somewhere in between these two extremes.

Why is it important?

Operational transfer pricing implementation originated as *ad hoc* responses by taxpayers to IDRs from tax authorities. Over time, many taxpayers came to anticipate tax authority positions in subsequent audit cycles and crafted their intercompany price setting, monitoring and data gathering procedures accordingly. While this sort of reactionary approach is ordinarily sufficient to avoid adjustments and penalties in the local jurisdiction, (i) it does not consider the full range of benefits that can arise from a strategic and comprehensive implementation of operational transfer pricing policies and procedures, and (ii) it may not properly address forthcoming global regulatory changes.

Operational transfer pricing applications

In addition to intercompany reporting for transfer pricing documentation, there are numerous potential applications for operational transfer pricing, including but not limited to the following:

- Transfer pricing effectiveness;
- Regulatory compliance; and
- Document retention and maintenance.

Transfer Pricing Effectiveness

In most cases, the cross-border transfer of tangible goods gives rise to both income taxes and customs and duties levied on the purchasing entity. Specifically, a higher intercompany price translates to an increased cost-base for the purchasing entity and thus a relative reduction in reportable profits and income tax liability. On the other hand, customs and duties are ordinarily calculated—at least in part—as a function of the import price of the tangible goods. Accordingly, higher intercompany prices generally result in increased customs duties expenses.

Despite the inherent relationship between income tax and customs duties, tax administrations have traditionally addressed these issues in a disjointed manner; both from a regulatory and an enforcement perspective. As a result, taxpayers also frequently treat these issues separately.

However, the lack of *ex ante* coordination between transfer pricing and customs can lead to tax-inefficient positions, including double-taxation.

As an example, a client previously set its transfer prices for the sale of goods at the beginning of the year but did not monitor the prices throughout the year. At the end of the taxable year the client would make transfer pricing adjustments to bring the profitability of its distributors within an arm's length range. However, the distributors would pay customs and duties on a monthly or quarterly basis based on the contemporaneous import prices. As a result, the year-end transfer pricing adjustments created a discrepancy between the customs duties actually paid and those that would have been paid had the pricing been at arm's length as of the original transaction dates. By implementing a simple operational transfer pricing solution to review intercompany prices on a monthly basis, the client was able to reduce the amount of customs and duties it paid on an annual basis.

In addition to customs and duties issues that arise, in some jurisdictions the tax authorities do not accept year-end transfer pricing adjustments, or allow only upward adjustments to taxable income. In such cases, multinational corporations that do not monitor or actively manage their transfer prices throughout the year may be confronted with unfavorable adjustments under audit. Unlike taxpayer-initiated adjustments that occur within the reporting period, adjustments imposed by the tax authorities can be accompanied by penalties and interest, and may require lengthy competent authority proceedings to avoid double-taxation.

By setting and monitoring prices throughout the year, taxpayers can not only avoid double taxation, but also proactively target specific points within the arm's length range to increase tax efficiency and manage cash objectives.

Regulatory Compliance

As the transfer pricing regulatory footprint continues to expand, both with regard to the Base Erosion and Profit Shifting ("BEPS") project as well as local country requirements, tax authorities around the world have become more sophisticated in their approach to enforcement. Increasingly, tax administrations are focusing not just on the local taxpayer, but on the entire value chain and how the total system profit is "allocated" to each controlled participant.

In addition, on September 16, 2014 the OECD released guidance on transfer pricing documentation and country-by-country reporting that requires taxpayers to submit detailed information for each country in which they operate. The country-by-country reporting template, which includes a number of quantitative disclosures with regards to financial statement data and intercompany transactions, has been widely criticized by taxpayers who claim that it will create an undue administrative burden. Despite these objections, the OECD has finalized its recommendations, which will be implemented by certain tax jurisdictions as early as 2015.

As the regulatory environment continues to evolve, one thing has become clear: a reactive, *ad hoc* approach to addressing tax authority inquiries if and when they arise is no longer an effective way to manage a company's global transfer pricing risk.

Many of our clients have already begun to put in place relatively simple operational transfer pricing processes in order to get ahead of the new OECD requirements. Among other initiatives, we are working with clients to create customized local country reports that address the country-by-country reporting requirements and feed into a centralized repository of data managed by the tax department. Organizing this information has the added benefit of enabling our clients to proactively manage their intercompany transfer prices and, as discussed below, establish effective document retention and maintenance policies and procedures.

Document Retention and Maintenance

Creating a single location for the maintenance of all transfer pricing-related information, such as financial data, transfer pricing reports, intercompany agreements, pricing models, etc. is key to establishing an effective operational transfer pricing platform. Having direct access to all relevant information across the entire organization improves efficiencies in preparing transfer pricing analyses, documentation and adjustments, and reduces the amount of time and resources necessary to respond to inquiries from tax authorities.

How Peters Advisors can help

Peters Advisors has assisted several clients with large-scale operational transfer pricing initiatives. We can help you to put into place an operational transfer pricing framework that will enable your company to meet the upcoming regulatory challenges and increase the effectiveness of your intercompany pricing. Starting with the development and formalization of intercompany transfer pricing policies, moving toward building financial models to set, track, and adjust transfer prices, and ending with creating the appropriate tools to leverage the vast amounts of information, Peters Advisors can assist your team in all aspects of operational transfer pricing.

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