Operational TP: When tax function meets finance function

Frank Schoeneborn, head of global operational transfer pricing in the finance and accounting division at Merck Group with headquarters in Germany, looks at the practical problems in the implementation of operational transfer prices, illustrating the new tax risks stemming from these problems and showing how holistic management can be the solution.

In recent times recurring public debates on transfer pricing and potential shift of profits abroad have been taking place, prompted by some prominent tax avoidance models. The OECD's base erosion and profit shifting (BEPS) initiative is only one of the most recent developments in this field; transfer pricing has become the domain of tax experts around the world for many years. This trend increases the pressure on tax authorities to prevent abusive arrangements and to protect their tax revenues. The introduction of increasingly complex regulations with more and more documentation requirements for international companies is proof of that. The same applies for the recently published public consultation on TP documentation and country-by-country reporting (CbCR) as part of the BEPS initiative. On the corporate side, tax departments have prepared themselves accordingly and defend existing transfer pricing systems and methods based on intensive documentation work.

In practice, the importance of the operational implementation of transfer pricing outside tax departments is usually considered far less. But implementation difficulties and weaknesses in organisational processes and systems can result in serious consequences for a MNE group. This emphasises the fundamental necessity of a cross-functional approach between the tax and finance function to successfully establish an holistic transfer pricing management to limit fiscal risks.

New risks – when transfer pricing leaves the tax function

From today's point of view a comprehensive transfer pricing documentation to prove a MNE group's arm's-length policy must be considered a minimum standard only. It does not mean that MNE groups don't have any significant transfer pricing risks anymore. In the past, problems and subsequent additional tax payments after a transfer pricing audit primarily arose from defects in the documentation requirements and what is stated there. For instance, the transfer pricing documentation was not complete, did not cover all transactions or was not congruent throughout the MNE group, benchmark studies and functional and risk analyses were inappropriate or incorrect, contractual basics were missing or, if available, not complied with. Mainly formal aspects were the weaknesses when defending established transfer pricing systems.

But even if a MNE group with all its subsidiaries prepares all statutory formalities on transfer pricing documentation globally, transfer pricing is not done: there are further risks behind the surface. These risks are usually not immediately recognisable from a tax expert's point of view. Instead, they often can be detected somewhere in the organisation, its behaviour, the systems in use and underlying processes. Therefore, tax authorities can challenge MNE groups by auditing the operational implementation of transfer pricing, the management of daily transfer pricing processes and the operational data level. Tackling transactional data, systems and processes is a new opportunity to relatively easily detect weaknesses or proof errors within the MNE group's transfer pricing management. If the organisation cannot provide convincing evidence that it has established clear, stable and robust processes and responsibilities within the organisation, the arm's-length behaviour of the MNE group can be questioned. If there are lacks in control mechanisms, the economic and taxable earnings of the different MNE group companies are obviously subject to random outcome.

Many aspects and dimensions must be taken into account for the successful operational implementation of transfer pricing within MNE groups. Therefore, the following examination addresses a number of aspects on organisation, communication, systems and data, process and change management.

Define roles, find the right people and let them communicate

Transfer pricing has become the domain of the corporate tax departments. Tax experts deal with the relevant laws, develop and prepare transfer pricing documentation and internal guidelines. Typically with support from consultancies, they analyse functional and risk profiles, take care of benchmark studies and decide on applicable transfer pricing methods.

However, when it comes to operational implementation aspects of transfer pricing, it is not easy to draw clear boundaries between the tax function and other organisations of the MNE group. Tax departments will rarely deep-dive into systems to prepare profitability reports. The calculation and uploading of new transfer prices on stock-keeping unit level (SKU) into the ERP systems, for instance, is a task which will probably never be part of a job description of a transfer pricing expert working in the tax department. *A fortiori*, the development or adaption of appropriate financial reporting systems in terms of technical functionality and the embedding into the existing IT system landscape with existing data flows will be delegated to other functions.

Unclear responsibilities and organisational interfaces, overlaps between the roles and responsibilities of the tax department, accounting and financial analysts and Legal department, corporate audit and representatives from operational business divisions pose a real challenge. This cross-functional interaction should be clear and unambiguous. It initially starts with the creation of separate teams or the nomination of individuals with clearly defined responsibilities and job descriptions. When it comes to staffing of transfer pricing positions the personal background, skills and experience of the individual is essential. In rare cases only, tax consultants or lawyers should be able to work successfully in management accounting and finance areas and, *vice versa*, it is hard to imagine that a business-, process- and data-focused Financial Analyst is able or interested in deep-diving into the details of local legislations. In this respect, it is a key to success that the responsibilities and activities assigned to a manager fit to skills and expertise. Each employee involved in the whole transfer pricing process must contribute to the smooth process flow. Everyone – regardless of which department the employee is ultimately assigned to – must have a clear understanding of what its role is, as well as the responsibility of the adjacent area in respect of transfer pricing. This also includes the recognition that some decision-making, process authority and duties are outside its expertise and responsibility.

Another critical component of success is communication. Certainly all staff dealing with any kind of transfer pricing-related activities should regularly share information and talk to each other. But it is important that all really understand each other. The transfer pricing expert community in the tax function has developed its own language, so tax experts worldwide discuss transfer pricing issues to the point. But it is noteworthy that sometimes terms are used where other departments of the company could understand something completely different. Some terms with potential misunderstanding and confusion are probably ‘function’, ‘transfer price’, ‘calculation’, ‘transaction’, ‘documentation’, ‘benchmark’ and ‘report’. If it is not constantly ensured that everyone involved understands the content and message, serious misunderstandings with possibly significant negative consequences might occur. The organisation could implement, operationally, something else than what was originally requested or decided by the tax department.

Through close coordination and a culture of intensive information exchange, for example through joint transfer pricing roundtables, committees or *jour fixes*, a steady and comprehensive awareness regarding the importance of transfer pricing can be ensured. In addition, new concepts in transfer pricing can be discussed early in the view of practical implementation options or limitations. It can be painful when almost finalized projects supported by consultants have to be heavily re-worked because of the impossibility of practical implementation. The same may apply for transfer pricing guidelines which might be hard to understand for employees who are less familiar with transfer pricing principles. The final conclusion must be: “Talk cross-functionally as much as possible and make use of the same language!”.

Get your systems data right and set-up processes

To prove the adequacy of transfer pricing transactions to be at arm’s-length various transfer pricing methods are used to analyse the profitability levels. However, in most cases common ERP systems do not provide the required data for the different transaction types in a standardised way. A challenging but common defect can be found in non-standardised and non-harmonised product master data and non-transparent invoice and value chain flows. Differently deployed and non-harmonised ERP systems, inconsistent charts of accounts and structures complicate an efficient data analysis massively. Instead, data must be derived and conducted from many different systems manually. The frequently used but by far the weakest solution is the extensive manual collection and recalculation of financial results of a MNE group company based on Microsoft Excel spreadsheets. Years later, in case of transfer pricing tax audits, such an offline approach is hardly stable and therefore not recommendable, in particular if the data and/or the responsible employee is no longer available due to staff turnover.

It has to be clearly stated that only with a suitable reporting system and appropriate IT platform behind an efficient transfer pricing management can be ensured. Transfer pricing analytics work will not take days or weeks, all data is always up-to-date, easily accessible in short-term or even years later at a fingertip. It seems that today there is no off-the-shelf solution available, therefore the design and operation of IT-based ERP and business intelligence (BI) software solutions will require investments, but the future

Global operational TP: Cross-functional interaction is vital

benefit is permanent. Thus, the procedural efficiency gain and the mitigation of tax risk should justify the expense.

A globally integrated and segmented profitability reporting according to the relevant transfer pricing transaction groups along the value chains will be a major challenge for the future for accounting, finance and IT. Tax experts may be surprised but the reason is that the focus from Finance and Accounting is totally different from the viewing angle which is applied from a transfer pricing perspective. Systems were simply not set up to answer questions on profitability in the relevant dimensions of transfer pricing. Guiding principles from IFRS plus internal management requirements were determining the scene. With BEPS, when global value chains come into focus, a new dimension of globally consistent and integrated data will be needed to evaluate what is really happening in an MNE group to understand the big picture. This is another evolutionary level of mindset and data complexity. Everyone involved from whatever background will have to lift his mind from local to global and must understand that systems and data might not be already available to meet these new data reporting requirements on short notice.

Another potential cause for problems is a gap in the process. The responsible person fails to perform the task successfully because processes were not well structured, not fast enough, the necessary profitability information was not available in the necessary level of detail or not available at all. Frequently, problems start with reference to the annual operative plan data used. Operative plans might be politically motivated or flawed. Also, the data quality at the planning level of individual companies may not be accurate and changes in data structures and processes do complicate a standardized approach. Some process defects can also occur as part of the continuous margin monitoring when the data is not available in the transactional aggregation. Even if the need for a transfer price update has been detected in time, there might still be problems in the calculation of new transfer prices. Besides the actual quantitative deviation an expectation or forecast for the rest of the period has to be considered when executing transfer price update calculations. A final risk in the process chain can be in the transactional data transfer, meaning if the new price data are not uploaded in a timely manner for daily business in the ERP system modules.

The last consideration is the potential personal behaviours of individuals. Transfer prices determine the local profitability of a MNE group company. Should incentive and bonus systems exist on operational or even levels of management that reward a high local result, a professional transfer pricing management including efficient processes is put at risk. Objective-setting systems determine the behaviour of the people involved and conflicts are unavoidable if a transfer pricing system is not aligned with management incentive systems. Such discussions delay transfer pricing processes and bind solid resources. Only once the incentive systems for management are decoupled from transfer prices, a transfer pricing organisation can work successfully.

Enter the new field of operational transfer pricing

Operational transfer pricing management includes the group-wide implementation (the ‘up’) and ongoing supervision and monitoring (the ‘running’) of the guidance as set forth by the corporate tax department concerning transfer pricing. It starts with the establishment of an appropriate organisation, the designing of the necessary cross-departmental processes and the set up of appropriate reporting systems for data analysis. In addition to the tax department as a triggering organisation it includes the accounting and finance departments, local finance organisations in the MNE group companies and potentially distribution and supply-chain organisations as well. Operational transfer pricing management should be an independent unit preferably being part of the accounting or finance organisation to foster a professional and dedicated performance.

The core task of the operational transfer pricing management consists of a continuously and not time-limited implementation of the specified transfer pricing principles and rules at operational (transactional) level for all MNE group companies. In daily business operational transfer pricing is responsible for the initial setting and updating of transfer prices including the data maintenance in the systems of the MNE group companies as well as the necessary communication to all affected organisational parts. It is responsible for an active and continuous monitoring of the financial results of the companies and turns the knowledge gained from variance analysis into corrective measures. Upon request, a specific transfer pricing analysis by the tax department is supported through adequate data provision applying reliable reporting systems customised for transfer pricing purposes.

Leading practices in the field

A key prerequisite for a successful operational transfer pricing management is the support of senior management. This may happen because top management has recognised the potential risk or it may be a result of painful experiences in the past. Operational transfer pricing management is performed cross-functionally. All repetitive processes are established. They run smoothly and in a standardised form. Leading practice companies have an integrated and unified ERP system combined with harmonised master data and reporting systems. A continuous monitoring of the actual intercompany results is performed based on year-to-date standard reports by using professional and advanced IT tools. Essential data analysis and margin reports are quantitatively reproducible at any time – even years later in the course of transfer pricing audits. Divergent trends in operating results of MNE group companies are recognised early during the year. After a short period of analysis, all additional data and information on special issues are obtained in adequate detail. A necessary calculation of new transfer prices on SKU level is processed in high quality and pushed automatically into the ERP system modules for daily transaction processing. The monthly or quarterly update of transfer prices on SKU level avoids major adjustment payments at year-end, saving time and resources. It lowers the tax risk caused by such measures, but on indirect taxes like customs duty as well. The regular financial reporting is not diluted. It is free from one-off effects due to transfer pricing issues. The development of the MNE group's tax rate is transparent and appropriate tax planning becomes reliable.

Leading companies have created resources and dedicated job positions for operational transfer pricing management, which were filled with highly qualified professionals. These experts cover a wide range of systems and process expertise and provide excellent communication work. The cross-functional cooperation in the overall transfer pricing process is managed in an excellent way and all incentive systems for managers within the MNE group are disconnected from any transfer pricing dependent performance indicators. Both the MNE group's transfer pricing strategy and transfer pricing system were developed holistically, that means also with regard to the aspects of operational implementation. High quality in tax planning and the transparency on any potentially remaining transfer pricing risks have been achieved.

Operational transfer pricing management costs: An insurance premium

Without an efficient operational transfer pricing management there is a risk of increasing frustration in the corporate tax department, but also in accounting, finance and in the operational business divisions. Closing and financial statements are delayed, financial reporting is distorted, double work becomes usual and transfer pricing related circumstances have led to surprises. Due to unclear responsibilities existing, resources cannot be focused on economically important and truly decisive projects and activities. External observers are surprised by a fluctuating corporate tax rate of a MNE group. The results of lengthy and strenuous transfer pricing audits are not satisfying despite all effort made, significant cash-out takes place due to double taxation, interests and penalties. All employees dealing with transfer pricing are being criticised – mutual recriminations are likely to be one consequence only.

MNE groups are, despite some significant hurdles and necessary investments, well-advised to establish an operational transfer pricing management and regularly review how efficiently it is implemented and what quality or defects the current processes have. Constant questioning and improving of both systems and processes must be an ongoing task which will provide benefit to all parts of the organisation. Transparency, efficiency, speed and excellent communication contribute to ensure tax compliance for direct and indirect taxes. All elements will jointly – at least years later during tax audits – strengthen the MNE group's position in the defence of the existing transfer pricing system mitigating tax risk and therefore create substantial value for the company and its owners.

Operational transfer pricing management is not a one-off project. All associated costs can and must be considered as a kind of insurance premium, reducing financial risks and limiting potential damage to an acceptable dimension. This applies equally to the threat of reputational or brand damage in light of the public debate on aggressive tax-avoiding policies.

Tax to call finance now

Representatives from the finance, tax and IT functions will have to intensify their cooperation on transfer pricing to manage any upcoming challenges in particular when it comes to financial data reporting capabilities. In nearest future when the global focus will be the dominating one, data structures and reporting systems must keep pace with the fast-growing demands for transfer pricing data transparency. The OECD BEPS initiative sends clear signals what the expectations are and where the direction goes to. Consequently, tax experts of MNE groups are well-advised to approach their accounting and finance experts to ask what such data requirements like those proposed in the CbCR template might cause. Reporting systems and processes, data flows and the analysis of financial results, all these areas are traditionally the territory of management accounting experts and financial analysts and in these departments, a potential administrative burden would pop up.

In response to the upcoming transfer pricing challenges, a suitable solution definitely must be developed jointly by the finance and tax functions supported by IT experts.