Leveraging Technology in the Evolving Transfer Pricing Landscape

There is a changing paradigm in today's global economy that necessitates companies taking a closer look at their intercompany pricing processes to ensure that they can meet changing statutory obligations, the business needs of their management, and financial responsibility to their shareholders.

BEYOND DOCUMENTATION REQUIREMENTS

Traditionally, many companies have viewed their transfer pricing obligations as solely an annual requirement involving the documentation compliance with a particular jurisdiction's rules, based on the Arm's Length Principle (ALP). But this process is evolving as the economies around the world become more connected, and as multinational corporations feel greater pressure from individual countries to comply with local tax documentation requirements.

The emerging view is: it is no longer enough for companies to simply satisfy the annual documentation requirements. Government auditors are looking more closely into the details to determine not just whether a company's transactions meet ALP, but whether those transactions actually were following the policy as stated in their documentation. Failure of a company to look beyond the documentation requirements can lead to double taxation, erratic effective tax rates, and inefficient business processes, resulting in lost profits.

Factoring into this emerging view of transfer pricing policies is a new Organisation for Economic Cooperation and Development (OECD) whitepaper on Base Erosion and Profit Shifting (BEPS). This white paper is spawning a potential cascade of new detailed reporting requirements, which would go into effect in 2017, that will make corporations reconsider how transfer pricing details are reported.

For many companies this may seem like a far off requirement (similar to the discussion of the United States adopting IFRS) that they will "deal with" it when, or if, it is enacted. However, 2017 isn't that far away for a multinational corporation (MNC) to develop new processes to comply with the detailed country-by-country reporting that has been proposed by the OECD. Here are two immediate implications:

1. What if year-over-year comparison is required? If so, that would mean that 2016 data would require the same amount of detail as data for 2017. Most companies will want a year of reporting privately before reporting on public data; that requires 2015 data.
2. How long will it take a MNC to get its arms around its global data and processes?

Discussions surrounding country-by-country reporting are not just about changing documentation formats and activities, they also include the need for a level of transparency in the intercompany transactional detail that has been absent in all but a few companies globally, and certainly not publicly reported. In this new environment, companies will need to look to technology to assist in all areas of this process, as more resources aren't likely to be provided.

Transfer pricing is usually the last area of tax to embrace technology tools to assist in management of their process lifecycle, but without technology it will be impossible for companies to mitigate reporting risk and have the level of transparency to allow for the comfort in what will be publicly reported.

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TRANSFER PRICING'S NEW FOCUS

The focus of transfer pricing has traditionally been on documentation activities. While important, ensuring compliance with statutory requirements doesn't provide a company with risk minimization or effective rate protection.

Companies are required by auditors to provide detailed information to demonstrate compliance with ALP for intercompany transactions. Documentation typically comes in the transfer pricing lifecycle three to nine months after transactions have been completed and the year has ended. That timing can create an issue where intercompany pricing doesn't actually fall within the policy's defined profit ranges, thus requiring the company to find new, appropriate comparables to compare to the actual results in order to comply with documentation requirements.

The other option is for a company to book an out-of-period adjustment to get them into the range. However, many countries, such as China and Russia, do not permit these adjustments. This leads to double taxation and inaccurate income tax provisions due to the lack of transparency into what the tax expense will be in each country in which a MNC operates.

Its no secret that the day-to-day execution of transfer pricing operations has a direct impact on the profits of a company, whether it has been able to maximize profits in lower tax jurisdictions, or it has been able to adjust its tax reserves due to more certainty around its positions. In fact, a growing percentage of reserves that companies report on their financial statements are related to transfer pricing positions. If a company had better control and precision over its transfer pricing process, it could mitigate its risk of bloated reserves, resulting in a positive impact on its effective tax rate and a positive impact on earnings.

FINDING A BETTER WAY

Is there a better way for companies to minimize risk associated with their intercompany activities, but still be able to utilize tax efficient structures and be confident in the potential public reporting of results?

The key to achieving a better path toward transfer pricing reporting is to build more acceptable levels of transparency into a company's process and its reporting results.

Most companies lack transparency because the responsibility for the management of results and annual documentation lies with the local finance teams. But, for a large organization, simply knowing whether intercompany policies exist for new transactions is difficult, and those processes are often manually driven, which adds a new layer of complexity to the problem.

This means that most companies focus on those areas that are a priority, and deal with the consequences should they arise when an auditor makes that request.

Companies often have some process to review their intercompany transactions in relation to policy, but this is typically a manual task performed in multiple Excel schedules. This process is typically performed annually, possibly quarterly, but rarely monthly. Regardless of the frequency, the process requires dedicated teams preparing these schedules who often do not have the appropriate level of data that's ideal for the analysis. It is only through continual analysis of the intercompany transactions that a company can effectively minimize risk, lower reserves, ensure accurate tax provisions, and forecast a more stable effective tax rate.

Unfortunately, companies are often constrained by lack of visibility into internal systems. And, the existence of multiple systems globally and resource availability makes the process an even greater challenge to perform at more frequent intervals.

TAX TECHNOLOGY AS A SOLUTION

In order for companies to effectively manage this entire process within the transfer pricing lifecycle, companies should consider utilizing technology to ensure they are complying with its own policies and can prove it under audit with detailed records from its accounting system.

To understand the technology landscape and what combination of technology can help companies reach more effective and timely levels of reporting accuracy, there are several factors to consider in designing a new process and employing technology to facilitate the process.

1. **How many local general ledger systems exist globally?** It isn't unusual for a company to have multiple systems around the world, and while it may consolidate into a single system, the consolidation level of data is insufficient to produce reporting that is meaningful for transfer pricing, to either measure appropriate profit or gross margin by each product, segment, or operational function. Further, where a company is highly acquisitive there is a greater likelihood that a company will have multiple systems making it a greater challenge to get timely access to the detailed level of data to perform the analysis.

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2. **How many people are involved in this process worldwide?** Typically, the process entails working with the local controller and others located in each country to gather the most appropriate data to perform an analysis of the income statement accounts, which is then processed by functional areas to validate the profit for each one according to the appropriate transfer pricing methodology. Moreover, there is often information that isn't contained within systems, which is needed to collect in a mechanized fashion and use it efficiently.

GLOBAL VISIBILITY INTO DATA

Where a company has multiple enterprise resource planning (ERP) systems globally, having access to all of its data, including appropriate account balances and detailed transactional information, is critical to producing segmented financials in order to determine whether the intercompany activity is priced according to the stated policy.

Dedicated tax data warehouses, separate from a company's ERP system, often provide companies the ability to centralize this data for tax purposes and enable the application of tax specific rules to generate the required segmented financials.

Tax data warehouses can empower the tax department with access to data not previously available. Ideally, it offers the ability to define rules that apply to the monthly or quarterly transactional or account level data to produce the segments, in order to identify specific product code, product group, accounts, cost centers, divisions or some other data dimension to define and determine the appropriate segment.

Being able to automatically compare the operating profit or gross margin against the defined policy allows a company to target those areas that are potential candidates for either journal entry or product price adjustments. This puts the burden of the production of reports and rules on the technology, and frees tax department personnel to focus their time on value-added activities such as research and problem identification within a particular product, entity or function. Tax data warehouses also can provide companies information that may be useful in business optimization, such as supply chain management, and more accurate forecasting.

PROCESS MANAGEMENT TOOLS OPTIMIZE GLOBAL COMPLIANCE

Having access to data with the ability to easily monitor compliance may not solve all the problems a company has relating to its transfer pricing process. Other technology solutions can complement overall transformation management, and help to design an optimal transfer pricing process.

In some cases, companies have looked to process management tools to provide specific tasks and due dates. This may be through a vendor specific tool for tax, or more generic organizational tools, as well as document storage. These tools can provide a framework in which a company can gain greater control to ensure full global compliance with requirements and policy creation, while at the same time, minimizing some of the risk associated with transfer pricing.

The use and application of process management tools should be part of the implementation of procedures to establish rules that ensure processes can be easily followed and replicated, and are transparent to the necessary parties. Where available, the workflow process should be integrated and related to the monthly/quarterly review of the intercompany activity. The workflow process can highlight a new trading pair, which will require the creation of intercompany agreements by the legal team, and sets up a due date for annual compliance in a new country.

These tools can also facilitate easy notification and tracking of additional information requests, updates to the prices, and/or journal entries or invoices for the intercompany adjustments. Working together, these solutions can provide a company with the mechanism to not only review their financial results, but also track the interaction with various stakeholders globally and easily track review and compliance with the policy.

This process also provides the foundation for audit support, offering a system that provides the requested information, as well as the trail for the reasons and basis for any adjustment, whether the audit is related to transfer pricing, or even customs. This framework can provide the mechanism to collect or report the information that may be required under the OECD's proposed guidelines, and ensures a process will be in place when it is enacted locally.

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TECHNOLOGY IS DRIVING POSITIVE CHANGE

Never before has there been such a level of scrutiny placed on transfer pricing. What is absolutely clear is that the status quo for a company's transfer pricing process cannot be its go-forward strategy without recognizing that increased risk will accompany that choice.

Multinational corporations need to pay more attention to how they implement and account for intercompany transactions, rather than focusing exclusively on documenting their transfer policies. Technology can effectively manage intercompany activity to ensure that pricing can be defended; tax is not paid twice on profits; reporting compliance is achieved, and reserves are managed effectively. Companies that have implemented a comprehensive technology solution to automate all areas within the transfer pricing lifecycle have seen a material and positive impact on a company's risk profile, effective tax rate and overall financial performance.

This is a single area where the impact of technology can have a ripple effect on many areas of a company, even completely outside its initial sphere of operation.

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