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Practical Transfer Pricing Compliance in a Complex World

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In this article, the authors explore the complexity of today's transfer pricing environment and provide suggestions for multinational corporations to take a practical, commonsense approach in analyzing, benchmarking, and defending their related-party transactions.

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Since the introduction of modern transfer pricing rules in the 1990s, there has been an explosion of regimes worldwide. This has made navigating the transfer pricing environment significantly more complex for multinational enterprises. The changes in law and related guidance have been accompanied by greater scrutiny and enforcement by tax authorities worldwide, and increasingly also by penalties for noncompliance. Whereas 20 years ago generally only the largest MNEs paid significant attention to transfer pricing, today MNEs large and small have no choice but to devote significant resources to transfer pricing compliance. Moreover, changes in the compliance and enforcement environment show no signs of stopping.

After briefly surveying recent key changes in the transfer pricing environment, this article provides suggestions for taxpayers to manage their transfer pricing compliance requirements and mitigate audit risk in a practical yet robust manner.

I. Recent Changes and Implications

In recent years, the OECD has driven many of the changes in transfer pricing rules. While the United States has not formally adopted OECD guidelines into law, it has been active in implementing many OECD-driven changes in practice.

A. Expanded Documentation Requirements

The 2015 release of the OECD's final reports for the base erosion and profit-shifting project

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actions 8-10[1] and 13[2] set off a sea change in transfer pricing compliance. Action 13 introduced three-tiered transfer pricing documentation guidelines, with a master file, local file, and country-by-country report.[3] As of December 2022, more than 100 countries have implemented at least one of these requirements. Adding to the complexity, some countries, such as Italy and India, have additional documentation requirements that go beyond those included in the OECD guidelines, and public CbC reporting is just over the horizon in Europe and Australia.

While the United States has implemented CbC reporting, it is a notable outlier in not transitioning its transfer pricing documentation requirements to align with the master file/local file approach. Nonetheless, it is quite focused on pushing taxpayers to improve documentation quality.

B. Focus on Functions, People, and Risks

A key focus of BEPS actions 8-10 was ensuring that entities within an MNE group that perform key management functions and effectively control risks are appropriately remunerated. Along with new rules for control of risk, actions 8-10 introduced the concept of DEMPE, which stands for development, enhancement, maintenance, protection, and exploitation. Tax authorities worldwide have eagerly embraced DEMPE and control of risk concepts even outside their intended original focus on intangibles. Many tax authorities have used DEMPE concepts to take a deeper look at roles and responsibilities within the MNE group to understand who is making key decisions and contributing materially to profitability.

We have seen tax authorities propose adjustments based on shifts in where people are located (such as the addition of a new oversight role in a different jurisdiction or a highly skilled employee who moves between jurisdictions) triggering a DEMPE-based exit tax event, despite no intangible property, in the conventional sense, being moved. Tax authorities' novel applications of DEMPE are frequently difficult or impossible to square with the text of the OECD guidelines.

C. Heightened Scrutiny and Enforcement

Many tax authorities have begun to expect more robust details in transfer pricing documentation, and some have taken steps to ensure that documentation is prepared contemporaneously. For example, some tax authorities (such as in India, Belgium, and Mexico) require certain transfer pricing information to be filed online or otherwise disclosed as part of the tax returns. The United Kingdom is introducing mandatory transfer pricing documentation requirements from April 2023 for large MNEs that include the master file and the local file. Subject to an upcoming public consultation, it also plans to require a summary audit trail document to detail the main actions MNEs take in preparing their transfer pricing documentation.

Transfer pricing has for some time been an IRS enforcement priority. With new IRS funding from the 2022 Inflation Reduction Act (P.L. 117-169), and authorization for the agency to hire up to 10,000 employees annually through fiscal 2027, one can expect a significant increase in U.S. transfer pricing audits.

Moreover, the IRS has announced it will take a harder line in evaluating the robustness of documentation and assessing potential penalties. In a 2017 directive to its examiners, the IRS said transfer pricing documentation should be evaluated for adequacy and reasonableness when determining whether penalties apply. In 2020 the IRS published a list of frequently asked questions to clarify the quality of the documentation it expects. The IRS FAQs are not law and do not displace the regulatory standards for evaluating the sufficiency of transfer pricing documentation,

[1] OECD, "Aligning Transfer Pricing Outcomes With Value Creation, Actions 8-10 — 2015 Final Reports" (2015).

[2] OECD, "Transfer Pricing Documentation and Country-by-Country Reporting, Action 13 — 2015 Final Report" (2015).

[3] The master file requires specific information to provide tax authorities an overview of the multinational group's business; the local file provides detailed information on the intercompany transactions under review and the economic analysis supporting the arm's-length nature of the transactions; and the CbC report provides select tax and financial information aggregated by tax jurisdiction.

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but they reveal a heightened focus on transfer pricing penalty enforcement.[4]

Tax authorities are also scrutinizing the CbC reports that are automatically exchanged between tax authorities. Increasingly, taxpayers are seeing tax authority audits driven by CbC reports. In some cases, these audits are triggered by red herrings. That is, because of a lack of nuance in the CbC reporting framework or because of errors in compiling the report (or the underlying data), concerns are raised about arrangements that are in fact reasonable. Taxpayers need to be aware of issues that might arise as a result of CbC reports and potentially address them in their master file or local file.

D. BEPS 2.0

In January 2019 the inclusive framework agreed to examine and develop proposals for the BEPS 2.0 two-pillar approach. Departing significantly from established international tax rules, pillar 1's amount A would formulaically reallocate profits, initially from about 100 of the world's largest and most profitable MNEs to market jurisdictions without regard to the arm's-length principle and traditional permanent establishment standards. Pillar 1's amount B is entirely different; it is intended to simplify and streamline the application of the arm's-length principle to baseline marketing and distribution activities. However, the compliance burden for MNEs to apply amount B may be cumbersome — the OECD's December 2022 public consultation document[5] contained proposed documentation requirements that are in many respects more extensive than the OECD local file requirements.

Pillar 2 of BEPS 2.0 is intended to address tax arbitrage by instituting a global minimum tax for MNEs that meet the threshold for filing a CbC report. Pillar 2 has gained steam with many jurisdictions, including those in the European Union planning to implement it starting in 2024. In December 2022 the OECD released information on a transitional pillar 2 safe harbor based largely on CbC reporting data. Using the safe harbor would significantly minimize the pillar 2 compliance burden for MNEs — but they must analyze whether their CbC reports are qualified and whether they are comfortable relying on their current CbC reporting data for this purpose.

II. Practical Considerations

Keeping track of the transfer pricing requirements for each jurisdiction can be a herculean task. The challenges are compounded by the increasing proliferation of rules that are intended to combat perceived tax abuse. These rules are enforced with heightened tax authority scrutiny and penalties. Thus, transfer pricing compliance cannot be treated as an afterthought; it demands due consideration upfront.

There is no magic bullet for managing all this complexity. What is required is a methodical (rather than ad hoc) approach to compliance. Creating this order means (1) establishing the right processes to institute supportable transfer pricing policies, (2) collecting and processing data to track transfer prices, (3) instituting governance to ensure responsibility, and (4) analyzing needed changes to transfer pricing policies.

To this end, we provide the following seven "rules of the road" for implementing a practical yet robust transfer pricing function.

Rule 1: Have a holistic transfer pricing policy.

With tax authorities embracing DEMPE and control of risk concepts and scrutinizing whether activities across an MNE group are appropriately remunerated, it is no longer sufficient to set transfer pricing policies by focusing on the facts and circumstances of each intercompany transaction on a stand-alone basis. This is especially true as the CbC report and master file give each tax authority a broader view of an MNE's business than they have had historically.

For instance, a tax authority reviewing an MNE's CbC report may question why the MNE's manufacturer in its jurisdiction is earning a lower profit margin than the MNE's manufacturer in another jurisdiction. Or a tax authority may assert the performance of DEMPE functions in its jurisdiction that should receive nonroutine returns, for example by pointing to personnel

[4] Recently and repeatedly, IRS officials have said taxpayers should expect more transfer pricing penalties to be asserted in the hopes that this will lead the IRS to receive more robust documentation. *E.g.*, Kiarra M. Strocko, "IRS May Assert More Penalties for Transfer Pricing Documentation," *Tax Notes Int'l*, Sept. 26, 2022, p. 1575.

[5] OECD, "Public Consultation Document, Pillar One — Amount B, 8 December 2022 — 25 January 2023" (2022).

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undertaking any sort of research and development activities.

One important way to address these tax authority challenges is by viewing transfer pricing policies through a holistic lens. Often this means undertaking a value chain analysis to document the key activities and risks of the MNE group as a whole, analyzing their relative contributions to revenues and profit, and identifying which jurisdictions are performing the high-value-adding versus routine activities and risk control functions. MNEs should consider including key parts of this analysis in their master file.

Transfer pricing policies that are aligned with, and consistent with, the value chain analysis help provide taxpayers with a sound and reasoned basis with which to respond to tax authority scrutiny and challenges.

Rule 2: Prepare a transfer pricing manual and share it internally.

With the long-term trend of increased globalization, companies large and small are operating cross-border and having to navigate increasingly onerous transfer pricing rules. At the same time, they face heightened scrutiny of the transfer prices from tax authorities eager to protect the national treasury. Even the largest MNEs with dedicated transfer pricing staff struggle to comply with transfer pricing requirements.

One approach to coping with these heightened requirements is to have a transfer pricing manual memorializing the MNE's transfer pricing policies and their implementation. The manual may be a single comprehensive document or a series of linked documents. In either case, it should ideally detail the MNE's transfer pricing policies and underlying rationale (with due consideration for Rule 1 above), include the pricing framework for each transaction type, and discuss how transfer prices are implemented and managed on an ongoing basis (for example, identify the data needed and who collects it, what calculations are needed and who prepares them, who is responsible for review and adjustments, etc.).

The transfer pricing manual would provide a roadmap to the MNE's transfer pricing policies and set out the processes to ensure these policies are being implemented appropriately. The manual sets the foundation for the MNE's transfer pricing compliance documentation and potentially simplifies resources devoted to annual compliance, as well as provides support to defend transfer prices in the event of an audit. In effect, the manual serves as the MNE's institutional memory.

This manual or a condensed version thereof can be shared with relevant functional and business owners in the MNE group to help them understand the need for transfer pricing, what the process is, and who has responsibility, and to educate them to alert the tax department when material changes in facts occur.

A transfer pricing manual that is comprehensive would also provide guidance in setting and implementing transfer prices for new intercompany transactions, understanding the effect of changes in facts on transfer pricing policies, and avoiding stand-alone ad hoc decisions that may create concerns with consistency regarding the other transfer pricing positions taken. In some cases, the manual may be used to demonstrate to the MNE's auditors controls over the financial reporting process.

Rule 3: Don't assume facts or that the tax environment remains the same.

The facts and circumstances on which transfer pricing policies are based are not static. Similarly, tax authority concerns and priorities evolve over time.

For example, an MNE's value chain analysis may have shown that key DEMPE functions and control of the R&D risks are being performed by a particular jurisdiction. But given continuing globalization and searches for talent that look beyond national borders, a new head of R&D is appointed in another tax jurisdiction — or the current head of R&D, for personal reasons, moves between jurisdictions — and this individual builds out a supporting team and the associated DEMPE functions in this new jurisdiction. Without ongoing monitoring, this change in facts may get missed.

Also, even if tax authorities have historically accepted the MNE's transfer pricing, they may not continue to do so. Evolving rules, interpretations, and areas of scrutiny by tax authorities may call into question historic practices and require a

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reassessment of the MNE's transfer pricing policies. Recent litigation highlights that even in cases in which the IRS has signed off on a taxpayer's transfer pricing approach, it may change its stance in the future.

Trying to identify changes in facts or tax authority focus areas on an ad hoc basis is not a recipe for success. It is inevitable that changes may be missed or not timely accounted for. It is crucial to have periodic reevaluations of the business and associated value chain to identify material changes in facts, and to identify implications of changed rules or enforcement priorities.

Rule 4: Have the data and technology tools to support your transfer pricing.

Having the right data is key to measuring and managing the MNE's transfer prices. Making sure this data can be relied on is a must to demonstrate compliance with transfer pricing rules and to provide support in the event of a tax authority audit.

Obtaining reliable data can be a challenge. This may be the case even if the MNE has relatively few or potentially straightforward intercompany transactions, such as management services fees or the sale of products to one or two jurisdictions. The data may need to be extracted from the MNE's enterprise resource planning system, or trial balances, or manipulated to obtain the transfer prices actually charged. If this is a manual exercise, as is often the case, it is expected that the process may be tedious and could lead to error.

A manual data process may also mean that the transfer prices are not checked as regularly as they should be to ensure compliance with transfer pricing policies, or that transfer pricing adjustments are not timely made. Further, the effect of tax planning or changes in facts on the transfer pricing results may not be easily ascertainable. The MNE may also not be able to easily prepare legal entity forecasts when the legal entity financials are materially dependent on transfer prices.

Technology tools can simplify the process of obtaining and manipulating data, calculating transfer prices for each intercompany transaction, and producing reports that can help identify deviances from policy or planning opportunities. Depending on the MNE's needs, this may entail various linked Excel models to which raw financial data are downloaded, or something more complex and built into the MNE's enterprise resource planning system.

Whatever technology approach is taken, one cannot develop the right tools or models without first spending time to ensure that the transfer pricing policies are supportable and aligned with the business (Rule 1). The usage of these tools or models should ideally be memorialized in the transfer pricing manual (Rule 2).

Rule 5: Actively manage your transfer pricing.

It is not enough to do all the things discussed here and then hope for the best. It is not unheard of for taxpayers to expend significant resources on transfer pricing and assume all is done. Without active management and a governance system laying out roles and responsibilities of who implements, who reviews, who approves, and when, an MNE's transfer prices could go off track.

Facts underlying transfer pricing policies can change, and data sources used to set transfer prices may become unreliable. New upcoming rules such as pillar 2 may require revisiting existing tax structures, or there may simply be too many ongoing adjustments to the transfer prices (which can be problematic, for example in sales of tangible products that are also subject to customs duties).

Part of having a robust transfer pricing function is strong governance to promote ongoing measurement, management, and review of the MNE's transfer pricing policies and implementation. This is good practice that could help avoid issues with both annual transfer pricing compliance and tax audits and is particularly helpful for applying Rule 3.

Rule 6: Have a documentation compliance strategy.

Taxpayers often do not have a clear and holistic strategy for how they will meet their annual transfer pricing documentation compliance requirements. All too often, the strategy is set by the availability of budget — with ad hoc decisions made on whether an intercompany transaction should be documented and what level of effort should be devoted to that documentation. This approach may lead to

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unforeseen outcomes, such as the imposition of penalties.

Practically speaking, given the immense amount of annual compliance documentation required of MNEs, and the fact that resources are limited, there is a balance that MNEs need to achieve regarding the expenditure of resources and the level of detail provided in their compliance documentation. MNEs need to reach a happy medium for this balance — and can use risk tiering as a way to do so.

What are the materiality and risks of the MNE's subsidiaries and intercompany transactions? This is a multi-pronged analysis that includes practical logistical considerations in conjunction with an analysis of the overall aggressiveness of the tax authorities in which the MNE operates, the nature of the penalty regime in the jurisdiction, and the magnitude of the relevant transactions. This can help the MNE assign each of its affiliates a level of risk (such as low, medium, and high).

Practical compliance obligations play a part in driving how an MNE should allocate its resources for transfer pricing documentation. For example, if a tax authority provides only 20 days to submit a local language report, it would behoove the MNE to prioritize preparing this report before the requested date.

But practical compliance should be considered in conjunction with tax authority audit risk considerations. In a jurisdiction with material intercompany transactions or an aggressive tax authority, an MNE would also want to devote resources to prioritizing compliance. For example, the United States requires contemporaneous documentation for penalty protection but does not require that it be submitted annually with the tax return. However, many MNEs still prepare annual documentation for the United States because of the size of their U.S. operations and perceived audit risks.

With these considerations in mind, the MNE can prioritize the allocation of its internal and external resources, beginning with higher-risk affiliates or transactions. A low-risk designation could be appropriate when local transfer pricing documentation is not required and audit risk is low, compared with a high-risk designation for an affiliate that has significant intercompany transactions, local documentation requirements that materially deviate from the OECD approach, or high audit risk.

Rule 7: Assess alternatives and manage potential audit risks.

While following the preceding rules can assist with audit readiness, MNEs should not shy away from evaluating alternatives to manage their transfer pricing audit risks.

Advance pricing agreements have long been used by many MNEs to get certainty on their transfer prices. An APA may be beneficial if the intercompany transaction is considered high risk, if the volume of the transaction is significant, or if the taxpayer wishes to economize on future compliance requirements. APAs have become popular in many jurisdictions.

The OECD's International Compliance Assurance Program (ICAP) is another avenue for MNEs to engage with tax authorities and obtain assurance on their transfer prices and practically reduce audit risks. The program, which is relatively new, enables an MNE to potentially obtain assurance across several jurisdictions that its transfer prices are low risk. While the ICAP has many benefits, its outcomes do not provide true tax certainty in the way that an APA can.

There are several considerations to address before deciding to engage in an APA or the ICAP. Although they can simplify future compliance, these alternatives may be resource-intensive and are not right for all cases. The ICAP in particular may not be suitable if the intercompany transactions under review may be considered controversial or otherwise present higher risk. That said, APAs and the ICAP are important tools to consider in an increasingly complex transfer pricing environment.[6] ■

[6]The foregoing information is not intended to be "written advice concerning one or more Federal tax matters" subject to the requirements of section 10.37(a)(2) of Treasury Department Circular 230. The information contained herein is of a general nature and based on authorities that are subject to change. Applicability of the information to specific situations should be determined through consultation with your tax adviser. This article represents the views of the author(s) only, and does not necessarily represent the views or professional advice of KPMG LLP.

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