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Transfer Pricing and ESG, Part 2: Improving Governance by Operationalizing Transfer Pricing

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In this article, the second installment in a three-part series on the intersection between tax and environmental, social, and governance policies, the authors focus on ways multinational corporations can use operational transfer pricing as a mechanism to ensure compliance with their transfer pricing approach and their tax policy.

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Introduction

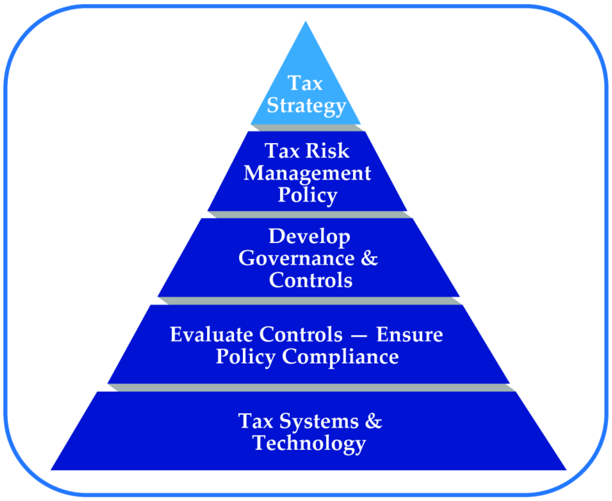
Internal and external stakeholders of multinational corporations (MNCs) continue to focus on environmental, social, and governance (ESG) policies, with an increasing demand to understand the MNC's approach to tax and transfer pricing. In the first article[1] of this three-part series, the authors focused on the role transfer pricing plays in establishing responsible tax practices and provided suggestions as to what MNCs should be doing in terms of tax transparency and transfer pricing. In particular, the authors noted that several of the standard-setters and rating agencies view a commitment to arm's-length principles for intercompany transactions as a significant guiding principle. Accordingly, they recommended that MNCs draft and publicly publish a groupwide tax policy that sets forth their approach toward key aspects of taxation, including their approach to transfer pricing. This tax policy is the first step in what is

[1] Jessie Coleman et al., "Transfer Pricing and ESG, Part 1: Public Tax Strategies and Tax Transparency," *Tax Notes Int'l*, Mar. 27, 2023, p. 1797.

commonly referred to as a tax control framework (TCF).

Once a tax policy has been developed and published, the next step for an MNC's TCF is to ensure the commitments made in the strategy are operationalized and implemented — essentially making sure the appropriate tax governance, risk management, and controls are in place. This is achieved by (1) developing a tax risk management policy (TRMP), (2) identifying and developing adequate governance and controls, and (3) evaluating the controls to ensure compliance with the policy. Most MNCs use systems and technology to operationalize and implement their tax governance. The figure depicts the TCF.

Tax Control Framework


Tax Strategy
Tax Risk Management Policy
Develop Governance & Controls
Evaluate Controls — Ensure Policy Compliance
Tax Systems & Technology

Even companies that do not have a formal documented tax policy (whether public or private) generally have some of the governance aspects of a TCF in place, particularly Sarbanes-Oxley controls regarding financial statements. The challenge for many tax departments is actually documenting the TRMP, including tax controls that address forward-looking, systemic risks and enhancing the TRMP as needed.

This second article begins by providing an overview of what the tax transparency standard-setters prescribe regarding good tax governance, discussing key MNC tax governance considerations, and providing an example of good tax governance in the transfer pricing area. The article will then explore how operational transfer pricing (OTP) — the methodology that companies use to effectively implement their transfer pricing policies — can assist companies to effectively implement and manage the intersection of their transfer pricing policies with their overall goals related to tax governance, controls, and risk management. Given the importance standard-setters and tax authorities have placed on transfer pricing in recent years, best-in-class transfer pricing systems generally include effective OTP measures that can be used to ensure an MNC's compliance with its transfer pricing commitments contained in its tax policy and processes.

Readers who are unfamiliar with the link between tax and ESG should start with the first article because the discussion in the second article further develops many of the concepts and ideas it addressed.

Tax Governance: What Say Standard-Setters?

Two leading standard-setters — the OECD and the Global Reporting Initiative (GRI)[2] — both emphasize the importance of tax governance.

OECD and the TCF

In 2016 the OECD released its report titled "Co-operative Tax Compliance: Building Better Tax Control Frameworks." In the report, the OECD provided specific guidance on the importance of a TCF and set out to define the elements of a robust TCF. The OECD's first principle is the creation of an enterprise-wide tax strategy. Many of the other principles are key governance elements such as assigning responsibilities for executing the strategy at all levels of the corporation, documenting governance to the strategy, and regularly testing performance under the strategy.

The OECD's report notes that a key element of an effective TCF is to have controls in place to operationalize the tax strategy (which could include transfer pricing practices). The governance guidance should define responsibilities; an approach to the identification

[2] GRI's reporting framework is one of the most prominent and widely used voluntary standards.

of materiality; how tax risks are identified, assessed, monitored, and mitigated; the modes of effective communication to embed tax in the organization; and key performance indicators related to tax. A robust TCF should have controls in place to ensure processes are followed and are subject to routine monitoring, testing, and maintenance. A testing procedure should be in place to monitor compliance with policies and the greater processes of the TCF.

GRI

GRI 207 is the tax section portion of the larger GRI 200's collection on economic reporting. GRI 207 is designed to help an organization understand and communicate its approach to tax, tax governance, control and risk management, stakeholder engagement, and management of concerns related to tax. GRI 207 contains four components, with one component focusing specifically on governance.

GRI 207-2, "Tax governance, control, and risk management," specifies that the reporting requirements concerning governance include three main sections: (1) a description of the tax governance and control framework; (2) a description of the mechanisms for reporting concerns about unethical behavior; and (3) a description of the assurance process for disclosure on tax, and if applicable, a reference to the assurance report, statement, or opinion.

Key MNC Governance Considerations

As noted by the standard-setters, after developing the tax policy, MNCs should focus on (1) developing a TRMP, (2) identifying and developing adequate governance and controls, and (3) evaluating the controls to ensure compliance with the policy.

Developing a TRMP

The TRMP sets forth a process that identifies, manages, mitigates, and escalates tax risks facing the organization. This will generally include use of a tax risk register identifying key tax risks (with a focus on forward-looking and systemic risks) and an assessment of the likelihood and impact of those risks. Because intercompany transactions are subject to significant tax risks, they should be included in the tax risk register when appropriate.

A TRMP should also explain the MNC's risk management plan. This can start with identifying the individuals who are responsible for dealing with tax risks, from identification of those risks all the way through resolution. A comprehensive risk management plan will include monitoring mechanisms and escalation thresholds, as well as mitigation processes for the different types of risks the organization faces. It would also state an MNC's tax risk appetite.

Adequate Governance and Controls

The next set of mechanisms that a TRMP should include are governance and controls to effectively manage and mitigate tax risks. Examples of controls include evaluating compliance with the tax policy (such as whether intercompany transactions are conducted on an arm's-length basis), the frequency at which transfer pricing documentation is reviewed, whether the MNC pursues advance pricing agreements where and when there are transfer pricing uncertainties, and several other controls.

Evaluating Controls to Ensure Compliance

Proper controls and processes should be put in place to evaluate whether the tax department is adhering to the policy. Ultimate responsibility for adherence to the policies and framework should also be clearly described. Questions such as these may be asked: Does accountability end with the head of tax, or is the chief financial officer (or somebody else in the C-suite) responsible for ensuring compliance? Likewise, does the board of directors or one of its subcommittees have a role to play? No two companies are alike in this respect, but ownership and accountability outside the tax department are strong indications that the organization takes tax governance seriously.

All organizations change over time. Accordingly, the TCF, including the transfer pricing policies, controls, and processes, should be evaluated regularly and updated as needed so that it stays fit for purpose.

Increasingly taxpayers are being asked about their governance, in general and specifically, regarding transfer pricing by the tax authorities. Many countries are implementing voluntary tax governance programs. For example, Singapore has implemented a tax government framework where companies can voluntarily participate to demonstrate good tax governance and enjoy benefits like extended grace periods for filing certain tax documents. Malaysia and Australia have similar programs.

Specifically with respect to transfer pricing — as part of the United Kingdom's business risk review process — many MNCs have received detailed questions related to their internal processes, systems, and governance regarding international tax and transfer pricing issues. The business risk review is a process for determining the risk rating for large taxpayers in the United Kingdom. This rating then dictates the intensity of the relationship with the tax authority. A low-risk taxpayer may not be subject to material review while a high-risk taxpayer would experience intense review. A formal part of the business risk review process is for the tax authority to analyze if the MNC's relationship with the government, its systems and processes, internal governance, and its approach to tax compliance tend to increase or decrease its inherent risk. Questions posed by the United Kingdom touch on understanding if the taxpayer has sufficient resources to cover transfer pricing operationally and, if the taxpayer does not, how that would be supported by advisers. A business with complexity that has limited transfer pricing resources and no external support would raise a risk flag.

A Transfer Pricing Example

Below, we've provided an example of how an MNC could use a TCF to ensure the transfer pricing commitments made in its tax strategy are operationalized and implemented. Assume an MNC shoe manufacturer has a tax policy that says all intercompany pricing is done on an arm's-length basis. Further, this MNC establishes a TRMP stating that intercompany agreements are required for all material intercompany transactions and all related transactions must follow the terms of those agreements. For an intercompany transaction involving the sale of shoes from the United States to Argentina, the intercompany agreement terms provide for an operating margin (OM) of 4 percent for routine distribution functions.

Further, at the close of each quarter as part of the governance controls, a transfer pricing manager is responsible for reviewing the actual results. At the end of the third quarter, the manager responsible for carrying out this activity under the policy discovers that the Argentinean distributor earned a 15 percent OM as opposed to the 4 percent target. The MNC's policy should clearly indicate how the manager is required to deal with this error. In particular, the policy should clearly describe the roles and responsibilities of persons up the organizational chain who need to get involved and when.

For example, the policy might indicate that any adjustment that is $100,000 or less is considered immaterial, in which case the manager is instructed to simply make the necessary adjustment and inform the immediate supervisor via email. Material adjustments, however, must be resolved through a formal process. This may mean, for example, that material adjustments are entered into the risk register and escalated to the head of transfer pricing before any adjustments are made. Errors in excess of an even higher amount may necessitate the involvement of third-party tax consultants or lawyers. Not all errors are equal; MNCs will likely have differing policies for immaterial risks compared with material risks and then further implement different policies depending on the types of material risks and the severity of those risks.

Tax Risk Management Through OTP

As it relates to transfer pricing, a TRMP should have clear, defined processes that describe how to set, calculate, account for, and review transfer prices for all intercompany transactions. Various OTP processes and technologies will help an MNC implement and manage the transfer pricing considerations within its TRMP. Generally speaking, operationalizing transfer pricing can ensure the agreement's terms are followed and that the transfer pricing calculations match the intercompany agreement by automating several transfer pricing steps, thereby reducing the possibility of human error.

In order to manage the risk, the MNC's OTP policies should:

- ensure that necessary personnel within the tax department understand when transfer

pricing processes are needed and what the processes are so personnel are available to execute the policies;
- identify tax team members who will take on the roles and responsibilities identified in the risk management plan;
- calendar a frequency for transfer pricing calculations — whether quarterly, biannually, or annually — to ensure that transfer pricing targets are met;
- calendar the frequency for review of transfer pricing documentation;
- implement a regular review of transfer pricing risk management;
- determine how transfer pricing risks are identified, managed, escalated, mitigated, and monitored; and
- require data standardization in order to create clean inputs into transfer pricing engines.

The MNC might also employ technology to further help manage its OTP processes. Examples of helpful technologies include:

- workflow solutions that automatically calendar processes, keep stakeholders informed of their requirements, and track the stakeholder review and approvals;
- data gathering tools that allow the company to manage complex ledgers and multiple enterprise resource system or data sources;
- central repositories that allow an MNC to centralize and store data (for example, agreements, data sources, transfer pricing reports, provision workpapers) in a location where any employee that needs the information can find it during the fiscal year or during an audit; and
- transfer pricing engines that reduce manual processes while at the same time provide standardized and transparent calculations that may be automatically reconciled.

Conclusion

Governance is becoming increasingly important to MNC stakeholders, and OTP reduces many unfavorable transfer pricing outcomes related to governance. Once processes and controls are established, implementing a system of OTP embraces risk-mitigating processes and controls, which lowers the potential for inefficiently addressing transfer pricing risks or overlooking them altogether. If an automatic process, like OTP, is implemented by an MNC, then that may remove not only the potential for human error, oversight, or simple mistakes, but it will also assist with saving time and resources. It will provide comfort to the tax department, the MNC, and the board of directors that the transfer pricing policies are being followed, and it will help in external audit and reporting.[3] ■

[3] 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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