Operational Transfer Pricing

Organise, Comply, Document

25 April 2019, Thursday

Facilitated by:
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Transfer pricing (TP) remains a main focus area of tax authorities around the world today. While groups like the Organisation for Economic Co-operation and Development (OECD) have been trying to seek international consensus and have issued various TP guidance, country tax authorities may choose to administer TP differently, leading to more tax controversies and increased risks of double taxation for companies. Companies can no longer rely on a patchwork of enterprise systems and ad hoc, manual activities to capture, calculate, monitor, and manage TP.

In a timely *Tax Excellence Decoded* session organised by the Singapore Institute of Accredited Tax Professionals (SIATP), Accredited Tax Practitioner (Income Tax) Elis Tan, Executive Director, Transfer Pricing, BDO Singapore, shared her expertise on how a well-constructed and executed operational TP framework is crucial for companies seeking to manage TP challenges in the current international environment.

Operational TP: What It Is and What the Challenges Are

Operational TP is the application of data management and analytics to manage TP data and processes, so as to enable effective and continuous implementation and monitoring of TP policies throughout the entire organisation.

Take, for example, a residual profit split TP model between an overseas head office and a Singapore subsidiary where the two entities are first allocated routine profits for routine functions, and then the residual profit (after deducting routine profit from total operating profit) is split among the two entities based on appropriate profit allocation drivers.

While such profit allocations may look straightforward on paper, they may not be so in practice as numerous operational TP challenges await. At the most basic level, data retrieved from the management information system (MIS) may not tie to the statutory or tax numbers based on which tax returns are prepared. Data may also change during the year (for example, headcount costs) and affect TP policy parameters. Additional efforts are often required to identify discrepancies and to adjust or update the data before it can be used.

Apart from data, another common challenge that companies face is the lack of ownership of TP issues within their organisations. This is partly contributed by the common misconception that TP concerns only the tax and finance functions.

To adequately tackle TP issues, a unified effort across various business functions is necessary. All business units must be cognisant that the transfer price of an intercompany transaction may require reassessment if the level of involvement of any group company is materially changed. Accordingly, each business unit must take up the responsibility to update the tax and finance functions on a timely manner to avoid exposing the organisation to unnecessary TP risks.

An Integrated Operational TP Approach

While operational TP is clearly relevant in the current business landscape, how can companies put in place a framework to address real life TP challenges? The answer lies in adopting an integrated operational TP approach.

An integrated operational TP approach encompasses people utilising technology and processes to plan TP policies, set up financial system infrastructures, monitor and analyse transactions, and scale up operational TP solutions to identify TP risks, determine TP adjustments and avoid large year-end adjustments. It can benefit an array of companies, especially companies with significant intercompany transactions, inconsistent TP results and companies that rely on manual processes for calculating TP.

PLANNING

Effective operational TP planning starts with a robust global TP policy that is supported by appropriate economic analyses consistent with the functional and risk characterisations of the local underlying entities.

Accredited Tax Practitioner (Income Tax) Elis Tan, Executive Director, BDO Singapore, shared her insights on Operational TP approach.

Intercompany agreements that are aligned with the substance of the transactions are important, together with a global governance model with clearly defined roles and responsibilities which monitors for compliance and consistency. There must also be contemporaneous TP documentation demonstrating that the TP outcomes are at arm's length.

SYSTEMS

TP policies, no matter how well prepared, will be meaningless if they are not supported by an adequate financial system infrastructure. Setting up the financial system infrastructure, however, is not an easy task as the financial system needs to fulfill two disparate needs. On the one hand, management demands line reporting at both global and divisional levels. On the other hand, statutory requirements (including legal, tax and accounting needs) need to align at legal entity and geographical levels. Ideally, the financial system should be robust enough to capture information to fulfill both management and statutory needs, and flexible enough to incorporate adjustments where necessary.

MONITORING

Different organisations adopt different approaches to monitoring. Some choose to "firefight", only resolving TP issues as they crop up. Others are more proactive, continuously monitoring the TP process throughout the year. Yet others may prefer a middle-of-the-road approach by performing ad hoc analysis on entities based on their risk levels, with riskier entities receiving greater attention.

The exact approach that an organisation adopts generally depends on its risk appetite and the resources it has. While continuous monitoring (often with the use of data analytics tools) is the least risky option, it is also resource intensive and may not be viable for every organisation.

SCALABILITY

Scalability is an important consideration when implementing operational TP solutions. Ideally, the operational TP solution should be transferrable and equally applicable to a range of entity characterisations. In addition, it should also remain relevant as the business environment changes and complexities grow.

Ultimately, the whole organisation should be able to rely on the same set of tools to leverage a standard dataset to perform the same types of analytics, while at the same time maintaining the flexibility to customise the solution based on unique country requirements.

As an illustration of a scalable operational TP framework, consider a global service fee model. Here, the regional cost centres charge their expenditures to the global headquarters. These costs (sans shareholder costs) are then pooled with global headquarters' expenditures and allocated to the group entities based on the time spent by global and regional personnel in supporting each group entity. A scalable operational TP framework must be able to extract cost centre information consistently to arrive at an accurate cost base.

The organisation must also standardise its definitions for each type of costs (for example, what is shareholder cost) to minimise subjectivity in questionnaires.

Local country regulations are also pertinent and must be catered for in the framework; for example, in Korea, overseas entities cannot provide certain functions to local entities. Separately, organisations should also consider keeping a mechanism to disallow costs if certain service charges are not made for commercial reasons (for example, global headquarters may have a policy not to allocate costs to the smaller subsidiaries).

Accredited Tax Practitioner (Income Tax) Elis Tan answered questions on the operational aspects of TP.

Best Practices Across the TP Life Cycle

Key stakeholders, particularly those knowledgeable about the organisation's intercompany transactions, should be involved right from the start at the planning stage. Committees may also be established to identify cross-border activities and develop strategies to address new intercompany transactions. In addition, formal communication, training and management programmes may be introduced to the wider audience within the organisation if necessary.

At the implementation stage, organisations need to ensure that there are sufficient systems and proper TP processes are in place. Sophisticated and expensive systems are not a necessity, so long as TP calculations and reconciliation can be performed effectively. Organisations should also ensure that the form and substance of their intercompany transactions align.

Monitoring of TP positions is best done through an automated monitoring process where the organisation is also able to adjust discrepancies in the transfer price in a timely manner. As a best practice, a responsibilities matrix can also be established.

It is paramount that management recognises the heavy costs of inappropriate TP positions and that employees do not see TP as a mere compliance requirement. To emphasise the importance of TP, management could identify the departments responsible for monitoring, escalating, modifying and evaluating TP, and could even consider adding TP as a key performance indicator (KPI) to influence employee behaviours.

Finally, companies must also be able to articulate business realities and substantiate the arm's length nature of related party transactions in their TP documentation. It is also important to ensure that the TP positions as stated in the TP documentation are coherent with the actual intercompany transactions and other statutory filings (such as the local tax returns). Any discrepancies should be explained.

As TP remains an important focus area by tax authorities, it is up to companies to manage their TP risks. Operational TP may just be the answer.

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