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POTENTIAL TRANSFER PRICING PITFALLS MULTINATIONAL ENTERPRISES CAN AVOID

Introduction:

Businesses today have leapt over geographical and economic barriers – and how! Factors such as access to foreign capital, conducive economic policies, and globalization have spurred businesses across industries to set their foot into jurisdictions beyond their home ground. International tax obligations, including transfer pricing, are a critical piece in managing a global business and should not be overlooked. While mapping their taxation approach, MNEs must consider the taxation policies and regulations of all the business entities' jurisdictions. The business landscape is changing rapidly, as are the related monetary and taxation policies globally. The dynamic environment adds to the pressure on MNEs to continually align their transfer pricing arrangements across jurisdictions and adapt their international taxation strategy to the developments.

This article will highlight the six critical transfer pricing icebergs that multinationals should avoid to keep the ship sailing smoothly.

1. Misalignment between contractual arrangement and business operations augmentation services

Analysis of an intercompany transaction from a transfer pricing standpoint finds its basis in a contractual agreement. By definition, the contractual agreement sets out the roles and responsibilities, allocation of risks, terms, and obligations of each party to the contract. This approach is endorsed by the Organisation of Economic Co-operating and Development (OECD) in its transfer pricing guidelines.

To avoid coming under the authority's scanner, multinational enterprises (MNEs) should ensure that the business's actual conduct is in sync with the contractual arrangement while conducting the transfer pricing analysis. Any deviation in contractual arrangement and the party's actual conduct is considered a red flag by tax authorities, triggering further investigation to substantiate the arm's length nature of the transaction.

2. Disregarding long-term perspective while concluding on a business model

The market landscape is dynamic and competitive. Business models are rapidly evolving, accelerated by technological advancements and changing consumer needs. In a bid to expand faster, MNEs, often fail to build out a business structure or a model from a strategic lens. A sound

business model is commercially viable today, in the short term, as well as in the long run. Setting up a business model with a short-term perspective comes at the cost of future growth prospects and invites potential tax implications.

For example, moving intangible property from one jurisdiction to another, or converting a limited risk distributor to a full-fledged distributor as the business progresses may entail various challenges from tax and transfer pricing perspective. MNEs need to chalk out a well-thought-out business model that factors in tax and transfer pricing considerations. The model must also be agile, adaptable, and flexible enough to respond to the broader business dynamics and market vagaries.

3. Ignoring transfer pricing regulations of other jurisdictions

To meet compliance requirements, MNEs need to take into account the transfer pricing policies of the jurisdiction in which the activity generates income, as well as the jurisdiction that is charged for goods or services. The inter-company transaction may be at arm's length from one jurisdiction's perspective, while the other concerning jurisdiction's law might say otherwise. A lapse of this nature may lead to unilateral adjustment by the tax authority. Therefore, ensuring that the intercompany transaction is at arm's length from all the participating jurisdictions' perspectives is necessary.

4. Omission of local inputs while preparing a global transfer pricing report

Maintaining transfer pricing documentation for all group entities is an expensive and can be a long-drawn exercise. To make the documentation process efficient, MNEs generally prepare a group-level transfer pricing documentation based on the transfer pricing guidelines issued by the OECD. Such reports focus squarely on the headquarters, with limited data or information pertaining to foreign entities.

While this approach may check the compliance requirements of the headquarter jurisdiction, it might not contain sufficient information required by the tax authorities of foreign entities for their examination. Therefore, it is necessary to take relevant inputs from all the group entities' local personnel and document

as much information as possible related to the intercompany transaction and business activities to avoid further investigation from the local tax authorities.

5. Inconsistencies in the local transfer pricing report and other reporting requirements

The implementation of BEPS Action Plan 13 of the OECD mandates large MNEs to maintain three-tier documentation, i.e., a local file, a master file, and a country-by-country report. The automatic exchange of information between the tax authorities of various countries opens access to jurisdiction-specific information to different countries' tax administrations. In addition, certain countries require MNEs to file a separate form for the related party transactions.

With various documentation and reports circulating in the system, discrepancies between the transfer pricing report and other related reporting requirements could be a potential red flag. Therefore, MNEs must ensure that the transfer pricing study report is aligned with the different reporting requirements to stay off tax authorities' radar.

6. Not reviewing transfer pricing policies periodically

The market landscape is fast-evolving, businesses are pivoting, and tax regulations are not far behind in bringing new updates. The transfer pricing policies of MNEs should ultimately be in tandem with the market realities and business value chain. MNEs should periodically review their business operations in the light of new developments to ensure that their intercompany transactions adhere to the arm's length principles.

Any deviation from the arm's length standards should be amended, and the reasons for the amendments must be documented in the transfer pricing study report. It is also recommended that MNEs update the economic analysis annually to keep the tested party's margins in line with the industry changes.

A Quick Checklist for MNEs to Dodge the Transfer Pricing Compliance Pitfalls:

1. Ensure contractual arrangements reflect the true nature of the business operations.
2. Map business model with an eye on the tax and transfer pricing implications of future business plans.
3. Ensure intercompany transactions are at arm's length from all concerned jurisdictions' perspectives.
4. Garner relevant inputs from all group entities' local personnel to comprehensively document the intercompany transaction and business activities.
5. Ensure that transfer pricing report is aligned with the other local reporting requirements.
6. Review and adapt transfer pricing policies to market and business changes annually.

Conclusion:

While the article has delved into some of the most common transfer pricing pitfalls, the relevance of these aspects will be specific to individual businesses. MNEs need to look beyond a "one-size-fits-all" approach and develop their transfer pricing policies, keeping in mind the facts and circumstances applicable to their business. The sooner the MNEs start preparing their transfer pricing policies, the easier it is for them to achieve tax certainty and adapt to the global transfer pricing developments.

At KNAV, we serve numerous MNEs across the globe and help comply with transfer pricing regulations applicable in their operating jurisdictions. Reach out to us to chalk out a solid transfer pricing strategy for your business.

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