Tax Insights

from Transfer Pricing

Operational Transfer Pricing: Addressing the challenges of managing intercompany pricing adjustments

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In brief

Year-end transfer pricing adjustments have been and continue to be a widely used mechanism by companies to adhere to their transfer pricing (TP) policies and ensure compliance with local TP pricing regulations. However, albeit widely adopted, this mechanism poses various operational and tax challenges, from direct and indirect taxes to management accounting and reporting.

Finding the right balance in terms of process and methodology for determining and implementing periodic and year-end adjustments is subject to debate.

For consideration: In this Tax Insight, we explore some of the common challenges encountered by businesses in implementing and defending such adjustments, as well as practical considerations for determining an optimal framework to effectively implement TP policies.

In detail

Common challenges

Availability of fit-for-purpose data

Determining the correct transactional and legal entity margins, availability of good and timely data is one major challenge that companies have to manage. The calculation of adjustments, either prospective or retrospective, is typically underpinned by:

- A good understanding of the ownership and governance of the data needed to enable these calculations, which are typically owned and delivered by multiple stakeholders in an organisation (e.g., Finance, Commercial / Pricing, Supply Chain, Operations, etc.).
- Quality of the data — i.e., the ability to use certain characteristics and fields in a company's data to carve out a segmented profit and loss (P&L) statement for monitoring the execution of the TP policy at functional and transactional levels. This is particularly relevant for organisations in which legal entities perform more than one function or operate more than one TP policy.

- Timely availability and accuracy of both actual (particularly statutory) data and forecasts for in-year corrections with partial retrospective and prospective adjustments to reduce the risk of large year-end lump sum adjustments.

Other common roadblocks include:

- Fragmented data sources, including data being procured from multiple unlinked systems. As a result, substantial time is spent on gathering data and reconciling transactional data with legal entity P&Ls.
- Forecast and budget data that are predominantly prepared for management purposes and may not always include a legal entity, statutory or intercompany transactional view and dimension.
- Lack of good quality forecasts for determining the adjustment to price. This can be especially problematic in industries that are susceptible to short-term economic shocks.

Cash management and foreign exchange issues

An unplanned large year-end TP adjustment denominated in a non-functional currency can give rise to a foreign exchange exposure if it was not considered for hedging. In addition to the impact such an adjustment may have on tax payable in the various countries, an adjustment denominated in foreign currency may also be subject to foreign exchange control restrictions and cash flow management issues relating to settlement of such unplanned lump-sum adjustments.

Competing objectives between direct and indirect taxes

Downward adjustments to achieve arm's length profit

- Where the actual profitability is above the target level prescribed by the TP policy, companies could make a retrospective adjustment (debit) to their intercompany transaction values and/or a prospective adjustment to future transfer prices.
- Lump-sum retrospective adjustments not traced to a specific invoice or product / service often attract tax deductibility challenges even though they are intended to achieve an arm's length profit. In certain jurisdictions, such lump sum payments may be recharacterised in nature (e.g., as dividends) and attract withholding taxes and penalties.
- On the other hand, when such adjustments are attributed to specific intercompany transactions such as purchases or sales of products, these often pose indirect tax challenges, raising the question of whether the prices utilised to determine the previous import values were in fact accurate, and therefore whether the correct customs duties were duly accounted for.

Upward adjustments to achieve arm's length profit

- Conversely, where the actual profitability is below the target level, companies could make a retrospective adjustment (credit) to their intercompany transaction value and-/or a prospective adjustment to future transfer prices.
- If the adjustment is made to intercompany transactions for which an import value was declared and is dutiable, obtaining a refund from the custom authorities could be burdensome in some countries and lead to indirect tax costs to the business. Companies may choose to forgo the refund but provide for a subvention at or after the financial close. Such subvention has accounting and tax implications. For companies already under pressure with increasingly reduced financial closing times or getting its audited accounts signed, unplanned adjustments are often discouraged.

The trade-off between indirect tax and TP compliance often limits a company's ability to make pricing adjustments retrospectively without assuming an element of risk. Consequently, not only do retrospective pricing adjustments cause distortion in the allocation of profits and taxes — which will become even more crucial with the introduction of Pillar Two and the associated qualifying country-by-country reporting requirement — it also may cause statutory and internal auditors and tax authorities to be concerned over the reliability of internal processes, data, and governance of the company.

Though prospective price changes are preferred to retrospective adjustments, due consideration should be given to indirect tax impact, particularly where the price variations at the product level are material.

Common approaches to managing these challenges

There is no one standard approach to dealing with these challenges, but companies are increasingly looking to more effective adjustment processes with the aim of reducing reliance on large year-end lump-sum adjustments and adopting alternatives to proactively manage margins.

Improving price setting processes and TP forecasting abilities

TP processes should not be seen in isolation from other tax and non-tax processes.

Observation: Increasingly, companies are working to achieve greater granularity in their forecasts, aligning frequency and timing of forecasts with business forecasting cycles, and building these requirements into their regular business processes. Tax functions are exploring predictive analytics to sense-check forecasts provided by the business to mitigate the risk of significant deviations between forecasts and actual margins at year-end.

Increasing monitoring and computational capabilities

Though there can be many reasons why year-end lump sum adjustments may be needed, even when a company has taken proactive measures to avoid such adjustments, these challenges can now be managed to a large extent. Advanced computational solutions are now used by companies to handle complex, more frequent, and granular pricing adjustments down to the product or service level, accounting for time lapses between price adjustments and P&L impact, inventory revaluation impact and so on.

Reducing key-persons dependency

Tax and finance functions manage complex intercompany operations through deployment of dedicated headcount and resources. Historically, these processes were managed independently by key individuals with little documented standard logic to back up the outcomes.

Increasingly, companies have started to deploy computational and visualisation tools as a low-cost and basic form of automation for monitoring and calculation purposes. Some companies are factoring TP operational requirements into Enterprise Resource Planning system implementation or Finance Transformation initiatives. In between, companies that use multiple financial systems are investing in out-of-system solutions to extract and organise data, run what-if simulations, apply trend analysis and compute adjustments with custom duties impact factored in.

Aside from reducing inefficiencies and the risk of errors generated by a myriad of spreadsheets with exception notes that are legible only to the originator, use of technology has proven to be a very effective way of managing key-person's risk and improving traceability. This is particularly relevant in recent times where employee turnover has been high.

Finding the root cause and implementing a holistic framework

Before adopting any technology, it is important to first determine the root cause of the operational risks by understanding all the moving parts involved in the effective management of that risk.

Additionally, a well-documented and clear workflow process with defined roles and accountability is essential to gain the most benefit of any technology use. Processes still need to be efficiently designed and human behaviour may need to be addressed through role redefinition and performance measurement redesign.

The takeaway

Effective TP operations are an essential part of good tax compliance and governance, but also a key part of a company's efficient financial processes.

With increased awareness of in-house tax departments and a greater focus on operational excellence, organisations are becoming more open to exploring how their TP processes — e.g., monitoring and adjustment processes — can be streamlined and integrated with business forecasting and financial closing processes. Ultimately, the objective is to reduce year-end adjustments by improving monitoring capabilities and developing a more rigorous process to address variances in a timely manner.

Taking steps to avoid financial consequences and potential questions concerning a company's broader tax governance, internal processes and quality of data used is critical. Therefore, intercompany pricing adjustments, alongside other key TP processes, need to be appropriately managed and should not be an afterthought.

Let's talk

For a deeper discussion of how this issue might affect your business, please contact the authors below or your usual PwC contact in your territory:

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