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STRATEGIC TRANSFER PRICING RISK MANAGEMENT: NEW CHALLENGES AHEAD

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ABSTRACT

The paper deals with Transfer Pricing and it answers the call for specific studies investigating the relation between Management Control Systems and Transfer Pricing risk management. The research involves a multi-level case study carried out into a Multinational Enterprise based in North-West Italy.

Meanwhile data collection was being carried out, the selected MNE was under investigation by the Italian Revenue Agency on the matter of Transfer Pricing. The Authors had the opportunity to interview Group CFO and a member of the Board of Directors, directly involved in Transfer Pricing practices within the Group.

Findings show that MNEs are increasingly compliance oriented; international Groups' Top managers consider Transfer Pricing as a strategic tool to reach competitive advantages rather than a mere mean to reach tax savings. On the other hand, tax authorities are increasingly auditing Intangible related transactions, in line with the OECD reports, having gained a remarkable knowledge on Transfer Pricing practices.

MNEs adapt their Management Control Systems in order to better detect risky transactions and to elaborate better policies for the future.

MNEs, showing an increasing attitude toward compliant behavior and appear to be ready for Joint audits between different jurisdiction which would avoid double taxation risk and result into a mere reallocation of profit among different States.

Results foster the research on the topic of Transfer Pricing and provide useful insights to practitioners and Auditors.

Keywords: Transfer Pricing; Risk Management; Tax Compliance; Management Control System.

1. INTRODUCTION

The paper deals with Transfer Pricing, a topic that has been increasingly attracting attention by multinational enterprises and by tax authorities over the past decades.

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Transfer pricing practices indeed involve the choice of the pricing policy for transactions occurring among entities from different countries but within the same Group and, therefore, the potential (mis)allocation of taxable income among different tax jurisdictions in order to obtain tax savings.

OECD (2017) developed "arm's length principle" expressed in art. 9 of its model convention to prevent or to realign these undesirable outcomes. Under this principle, MNEs should set intercompany prices as independent parties would do.

Nowadays, most of the developed Countries have enforced comprehensive legislation on this matter and have introduced compliance requirements based on the Guidelines and recommendations provided by OECD (OECD: 2010; 2017).

As a direct consequence, tax authorities' sensibility on this topic has increased as well as tax audits aimed to find harmful transfer pricing practices, especially after OECD issued its Base Erosion and Profit Shifting reports (BEPS) in 2013-2015 that culminated in 2017 revised Guidelines.

Thus, the main aim of this paper is to start investigating how MNEs deal with transfer pricing and how recent evolutions within this environment have affected – or are affecting – them from different perspectives.

As literature shows, indeed, from a strategic point of view, Transfer Pricing represents a potential source of risk in term of financial and reputational losses; while from an operational point of view, the management control system has to respond and to adapt in order to cope with the ever-changing legislative environment.

Case-study was selected as the most appropriate methodology to investigate the evolutions on the matter as well as to ensure practical outcomes and guidance for professionals working in the field and for tax authorities since the paper captures some of the main concerns and expectations for years to come that professionals expressed around this topic.

The remainder of this paper is structured as follow: section 2 presents the relevant literature on the topic; section 3 introduces the case study and explains the research design, the methodology adopted and the conceptual framework to interpreter the findings. Section 4 presents findings while section 5 discusses them and draws the conclusions on this topic.

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2. LITERATURE REVIEW

The topic of Transfer Pricing gathered the attention of many different actors in the economic panorama as it represents a key issue for Multinational Enterprises, Institutions (tax authorities) and practitioners around the globe.

Recent studies by Consultancy firms (Deloitte, 2018; EY, 2014; EY, 2016) indeed show as Transfer Pricing has become a priority on the agenda of MNEs and Institutions over the past decades and even more after the OECD issued the BEPS report and more specifically actions 8-10 (OECD, 2015).

Transfer Pricing indeed, is associated with several risks within Multinational Organizations (Miller, 1992), e.g. double taxation and reputational risk. Double taxation risk occurs when a First country requires a transfer pricing adjustment on income of an MNE while a second country involved does not accept a corresponding adjustment.

Reputational transfer pricing risk occurs when a Multinational Group suffers from a transfer pricing adjustment that becomes of public domain with negative downturns.

Thus, many Scholars too have dealt with this topic investigating organizations' behavior from different perspectives. For this reason, it is possible to identify many streams of Literature on the matter.

A first part of the Literature indeed shows that Multinational Organizations' transfer prices are affected by tax rates differences among the Countries (Borowski, 1997; Colling & Shackelford, 1997; Clausing, 2003; Grant, et al., 2013). Another stream of Literature, on the other hand, focused on the outcomes of transfer pricing policies on Multinational Enterprises results (e.g.: Picciotto, 1992; Cravens and Shearon, 1996; Nichols and Conover, 2000; Bartelsman & Beetsma, 2003; Hanlon and Heitzman, 2010; Klassen, et al., 2017).

Other Scholars then investigated the main determinants of transfer prices changes within the organizations (Boyns & Edwards, 1999) or price determination (Bouwens and Steens, 2016).

Lastly, a stream of Literature focused on the countermeasures adopted by different countries in order to deter harmful practices by Multinational Enterprises (Eldenburg & Joanne, 2003; Chan and Chow, 1997 and more recently Borowski, 2010; Buus, 2018; Bosung, et al., 2018).

Even if Transfer Pricing is commonly perceived as mean to obtain tax saving and related extra-profits by shifting income towards States that apply lower income tax rates (Sikka and Willmott, 2010), many Scholars showed the strategic relevance of this practice.

For example, Cravens (1997) shows that Executives of Multinational firms consider transfer pricing as a strategic lever to obtain competitive advantages towards competitors. Similar results are presented also by (Plesner Rossing and Rohde, 2010).

According to this point of view, Transfer Pricing practices within the organizations have been analyzed in depth by many Researchers.

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As discussed above, Transfer Pricing is related to many risks within an organization, thus it has become vital over the past decades for MNEs to develop proper risk management practices also under the growing request of compliance by tax Administrations (Wunder, 2009). Compliance itself indeed is perceived as a risk within Organizations (Jost, et al., 2014).

In this sense, Hagigi and Sivakumar (2009) depicted an integrated framework for MNEs having to cope with exogenous and endogenous risks.

Literature also pointed out that a key success factor for risk management practices is the Management Control System "MCS" (Plesner Rossing, 2013): in this sense the Author elaborates on the *Levers Of Control* Framework proposed by (Ferreira & Otley, 2009) explaining how Intra and Inter-Organizational Interactions affect tax strategy and the Management Control System itself.

Despite all of these studies, major gaps still persist in Literature as shown by (Plesner Rossing & Carsten, 2014) in particular in understanding how MNEs deal with transfer pricing and how MCSs adapt to ever-changing tax context. Other gaps and open questions arise also in Martins (2017) that analyses the impact of new Accounting GAAP on comparables reliability.

This paper aims to fill the former gap and provide some insights about recent evolutions of transfer pricing practices.

3. METHODOLOGY

Research Design

The case study is guided by (Yin, 2009) (Yin, 2018). Case study research might be chosen when the research questions are "how" and "why" questions; when the researcher has no control over behavioral events and when he/she is focusing on studying a contemporary or new phenomenon. In other words, the case study is appropriate for an exploratory or explanatory phase of the research/investigation.

Moreover, case study represents an appropriate methodology when the research focuses on understanding real-world case in which the understanding itself is likely to involve conditions peculiar of the case analyzed as shown by (Yin & Davis, 2007). Therefore, case study methodology is open to the use of theory or conceptual categories that guide the research and analysis of data (Meyer, 2001) but it is also a reliable method to explore new theories (Eisenhardt, 1989).

Indeed, case study research guarantees for a holistic view of the process as argued by (Gummesson, 1988): "The detailed observations entailed in the case study method enable us to study many different aspects, examine them in relation to each other, view the process within its total environment and also use the researchers' capacity for 'verstehen' ".

For these reasons, multi-level case study was adopted as a reliable method to observe real world practices and to explore new evolutions and patterns in Organizations.

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In this case, the Research Question formulated is:

RQ: *How do Multinational Enterprises deal with Transfer Pricing Risk and How are Organization responding to recent evolutions in this environment?*

The case here presented analyses a Multinational Enterprise (hereafter also "MNE" or "Group") headquartered in the North-West of Italy. The Group is involved in two main lines of business: (i) the production and sale of milling machineries and (ii) the developing of Numerical Control Software linked to the milling machine or sold apart and installed on third party machineries.

In addition, MNE provides many services related the machineries and software sold.

The first Company of the Group was incorporated in the 1970s, after a couple of decades of stable growth, it started opening subsidiaries in Europe, United States, South America and Asia. This led the Group to face Transfer Pricing issues since the early '90s and thus to develop strong competences on the matter that motivated us to select it for this research.

The Group is deemed to have own peculiarities, but the conclusions drawn from this case study are likely to be observed during future steps of research involving further Companies as they represent practices developed in many years of experience and proved effective in several tax audits.

Indeed, "Group" structure reflects a rather common organizational path in Multinational Enterprises that centralize their Research and Development activities as well as their manufacturing operations, selling through a web of subsidiaries around the globe.

In this case, MNE located R&D in Italy, as well as most of the manufacturing activities with minor part in China through a joint venture. Subsidiaries are located in France, Spain, Germany, Brazil, United States and China and perform mostly distributive activities. Moreover, they offer maintenance services. For the purpose of the present case study it must be mentioned that MNE's products are highly customized to meet customers' specific needs.

Data collection

The case studied was conducted from February to May 2019, after an extensive reading of the literature on the matter and after having selected "MNE" as a reliable subject for the case study, the research strategy was designed.

Due to the high sensitivity of the information reported in the present case study, the Authors agreed with top management at MNE not to publish or divulge the name of the Company.

The authors carried out structured interviews with the Chief Finance Officer at parent company of "MNE" who deals with transfer pricing on a daily basis inside the organization.

Then, the Authors interviewed one of the members of the Board of Directors at the Parent Company of "MNE". More specifically, the Director deals on a daily basis with commercial matters. He gained a

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remarkable experience in his 33 years within the Group. In particular, he spent many years in each of the subsidiaries and this represented a major strength for the case study.

Lastly the Authors had the occasion to meet the President of the Board of Directors for a short informal meeting on the topic of Transfer Pricing.

The interviews were structured based on the relevant literature before every meeting in order to cover all of the topics under investigation except from the one with the President of the board of Directors at MNE.

The main interviews were audio recorded (total 3 hours and 15 minutes) and then transcribed (the interviews were conducted in Italian, any sentence reported in the "findings" section has been translated by Authors). After the transcription, the interviews were coded to link more reliably each part of the interview itself with each topic.

In order to enhance the reliability of the study, the coding activity was independently replicated by each of the Authors.

The Authors also had the opportunity to analyze some relevant material and to discuss future opportunities and concerns within the Transfer Pricing area for "MNE".

As said above, findings of this case study are likely to be observable also in other Multinational Enterprises.

Nevertheless, further case study may be replicated in different Multinational Enterprises in order to generalize results.

4. FINDINGS

Transfer Pricing Context

MNE has been developing its business outside Parent company's territory through subsidiaries since the second half 1980s and therefore has been facing Transfer Pricing issues over the last decades in terms of price setting, formalization of intercompany Agreements and Tax authorities' audits.

Transfer Pricing strategy at MNE focuses on dual objective: from a first point of view, MNE aims to comply with the main Regulation in each of the Countries involved in Intercompany transaction.

On the other hand, as also pointed out by the Group CFO, Transfer Pricing should represent a tool in order to achieve strategic goals balancing margin across the various subsidiaries.

Indeed, he argued that Transfer Pricing should represent, in an ideal world, "*the tool to reach the correct marginality in every subsidiary, which is functional to the final goal of the Group economic equilibrium*". Nevertheless, the CFO acknowledges that [Transfer Pricing] "*often represents a compliance tool that follows the business practices*".

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In this sense the Organization has developed a remarkable set of procedure in order deal with Transfer Pricing risks: indeed, both CFO and the Director highlighted that prevention is MNE's key success factor on the matter. The Director pointed out that the first complete analysis of the transfer pricing policy at MNE was conducted when opening the first subsidiary.

For example, MNE started to prepare documentation suggested by OECD well before the introduction of the rules avoid penalties in case of transfer pricing adjustment (in Italy penalty protection applies under art. 1, par. 6 of Decree 471/1997 since Tax year 2010).

This, helped MNE to develop a better documentation, refined in all of the aspects year after year, which created a standard inside the Company.

Despite this, it is worth noting that for the Master File Document, the Group still relies on external tax consultant, with a vast experience on the matter. "*This*", argues the CFO, "*is because the form is still very important when MNE has to explain its transactions to the Revenue Agency or to other Auditors*".

Moreover, the pricing policy is subject to a complete revision at least every two years. This process involves not only Finance Area and board of Directors, but also many functions among the Parent company and each Subsidiary involved in each intercompany transaction.

The Director argues about this procedure that "*past experience suggested us to deal with price setting and price revision gathering around a table all of the representatives from the entities involved and from the different functions. An adequate and equilibrate discussion among different Directors and managers would more likely result into a price similar to a negotiation between independent parties*".

Therefore, a preliminary questionnaire is sent to each of the functional area (Supply Chain, Logistics, Services Offices, Commercial). Each responsible then can make suggestions and give advices with reference to the transaction.

The questionnaire is also a valid support in order to understand whether relevant elements of the functional analysis have changed through the period.

Intercompany Sales of Goods

Part of the transfer Pricing strategy involves "*the consistency between the pricing policies with business transactions*", argued indeed the CFO, "*that is a crucial element to support the fairness of our conduct. MNE aims to apply the same pricing policy for every typology transaction independently from the country of the subsidiary. Indeed, MNE has a unique price list which represents the base from which the price of every intercompany sale is calculated through a discount rate*".

This policy may generate though, fluctuations among the margins between subsidiaries in different Countries and it may also alert the tax auditors during their audits, as happened in the recent audit. In fact, MNE has been inspected recently by the Italian Revenue Agency on the matter of transfer pricing (the Audit concluded with minor remarks during the period of our case study).

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"*The most difficult task that MNE has*", explained us the Group CFO, "*is to convince the Auditor in Italy or in the other Country that our decisions were driven by business opportunities and, for us, every single machine sold is somehow a "different business" from the previous one*".

MNE, indeed, has a catalogue of standard products that are fully customizable by the final customer when placing the order. The customer has the opportunity to share its needs with the technician at MNE and develop its own machinery which is then assembled directly at the customer's plant. To this extent every transaction may be considered different from the previous one.

Nonetheless, other elements must be taken into account: "*the Parent Company for example may sell one of his machineries to one of the subsidiaries realizing a tiny margin. This would probably be considered not acceptable by the Italian Revenue Agency, but the Intercompany sale may have been concluded anyway because the milling machine is going to be placed in one of the most advanced plants in the world and this will be an outstanding advertising for the Group*".

As part of the revision procedure, recently, MNE has also started to analyze each relevant intercompany transaction involving the sale of milling machineries. This represents a correction of the Management Control System, which enables a useful "ex-post" analysis to drive future price choices.

Indeed, the CFO argued that "*we are conducting a profit analysis using big data and data mining that will help us to understand what are the most profitable machineries and the subsidiaries that have higher margin. This kind of analysis would also support a different price policy if we deem that a subsidiary is earning a margin higher than it should*".

According to the CFO therefore, Transfer Pricing should be considered as an opportunity to reach a more in-depth knowledge of the Organization at MNE.

Transfer Pricing of Intangibles

Intangible and Value creation related to transfer Pricing analyses are central aspects of the recent Base Erosion and Profit Shifting report by OECS (2015). According to the OECD indeed, the profit allocation among the entities of a Multinational Group should reflect the contribution of every single entity to creation of value.

MNE centralized the entire R&D activity at the Parent Company's facilities in Italy where the Group located the main manufacturing sites. Nevertheless, MNE carried out an analysis about a possible transfer of know-how from the Parent Company to its subsidiaries.

In this sense, the CFO explained that "*the mere sale of a machinery does not involve the transfer of know-how. When Parent Company's technician provide services to foreign subsidiaries too, we do not transfer know-how*".

It is worth noting that the Company adhered to the Patent Box regime, which allows to relief the part of the income that a taxpayer produces through the direct or indirect use of Intangible properties (or intellectual properties under L. 190/2014).

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Under this regime, MNE concluded an agreement with the Revenue Agency in order to establish the correct amount of the profit gained from the use of the Intangibles.

Interestingly, the CFO argued on this topic "*Patent Box regime helped the Organization to carry out an extensive qualitative analysis of out intangible management*".

The Analysis pointed out that MNE dealt with know-how and intellectual property correctly both with reference to external and internal subjects.

This helped to enhance the overall knowledge and the consciousness of the problems related to intangibles: indeed, according to the CFO: "*Employees are one the most important ingredient of MNE's know-how*".

Transfer Pricing and Financial Transactions

Financial Transaction have been recently analyzed by the OECD in a specific working paper (2018) related to the Base Erosion and Profit Shifting report.

We found that intercompany financial transaction are material within the Group: this mainly due to the unfavourable payment terms negotiated with final customer.

MNE experienced several problems dealing with intercompany financing activities due to differences among jurisdictions (for example MNE was not able to include into a cash pooling agreement some extra-EU subsidiaries).

Nonetheless, the Group was able to manage excess of cash in non-EU subsidiaries thanks to dividend policies of intercompany financing.

Neither CFO nor Director anyway were aware of the latest document issued by OECD.

Transfer Pricing and Tax Audits

The Parent Company of MNE had been under investigation of the Italian Revenue Agency during the data collection period. Eventually, the audit closed with minor consequences for the Group, which may be considered a proof of a fair management of the Intercompany transactions.

Starting from the on-going Audit we had the opportunity to share some thoughts with the Director and with the CFO about how MNE deals with tax audits.

Based on their experience, it emerged that they were mostly concerned by the attitude of the Auditors: indeed, Transfer Pricing practices should be determined (and audited) starting from the business point of view. Sometimes, they complained, the Auditors lack of a global vision and, as said also above, the hardest task for taxpayers is to explain the fairness of the economic reasons behind the transactions.

Nonetheless they noticed that over the past years Tax Auditors have improved their knowledge on the matter.

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Moreover, the risk of double taxation arises serious concern at MNE: the CFO indeed acknowledged that Tax Audits carried out by a single jurisdiction lead to potential harmful conclusion for the Enterprises.

It would be much more desirable to face multilateral tax audits involving tax authorities from the jurisdictions interested by the transaction and the MNE Group: this would reduce without any doubt the risk of double taxation.

5. CRITICAL COMMENTS AND CONCLUSIONS

The case study gave significant insights about Transfer Pricing risk management in Multinational Enterprises.

First of all, findings confirmed the fact that Transfer Pricing is considered as a strategic tool coherently with previous literature (Cravens, 1997; Plesner Rossing and Rohde, 2010) and not only a mean to achieve tax savings through profit shifting.

Moreover, findings showed that Transfer Pricing strategies are focusing more and more on compliance oriented behaviours, as MNEs try to limit related risk (Jost, et al., 2014).

The MNE analyzed in the case appeared to be fully compliant with the current Italian Legislation: the top management showed interest on the topic and has proved to have a solid knowledge.

Nonetheless, the authors suggested a further review of the Intangible related transactions. Indeed,the revised version of the OECD Guidelines underline the importance of a correct profit allocation through a careful functional analysis having particular regard to the so-called "DEMPE" functions (Development Enhancement Maintenance Protection and Exploitation). In this sense for example (Peng and Lagarden, 2019).

It is worth noting that also different provisions are now affecting Transfer Pricing practices, such as Patent Box legislation.

This case study would also support contingency theory about Management Control System elaborated by Plesner Rossing (2013).

In order to answer to the Research Question, the case study shows that MNEs try to minimize Transfer Pricing risk through preventive actions and analyses. A strategic planning of the intercompany transaction, ex post analyses and compliance oriented programmes can lead to overcome tax audits without any double taxation or reputational downturns.

Also, in line with contingency theory, Management Control System adapt in Multinational Enterprises in order to respond to exogenous factors (e.g.: new regulation, new tax environment).

The case study suggests that MNEs are likely to evolve their MCSs in oder to better detect risky transactions and to allow corrective measures to transfer pricing policies.

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Lastly, OECD and Tax Jurisdictions are putting more and more pressure on MNEs requiring higher levels of disclosure. MNEs on the other hand are more and more compliance oriented and ready to face Joint audits involving more than one Jurisdictions. These would probably reduce the risk of double taxation, when no fraud is detected by Tax Authorities.

To conclude, this work answers to the call for analyses of Transfer Pricing practices within Multinational Enterprises. Even though the results are deemed to be likely observed in other Multinational Enterprises, further case study may lead to generalize them.

This paper can foster research on the matter of Transfer Pricing and to provide useful insights to both Practitioners and tax Administrations.

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