International Tax Review

October 2006 -

Culture must drive a winning policy

Having clearly defined functions within a company's tax department is crucial to a successful transfer pricing policy. The next step is implementation explains Herve Bidaud of Hogan & Hartson and Emmanuel Llinares of NERA Economic Consulting

Transfer pricing is a major concern for multinational enterprises. On the management side, well-managed transfer prices enable a correct allocation of resources within the company. Optimal management of transfer prices further involves: (i) securing risks associated with tax reassessments and (ii) benefiting from the opportunities that a suitable transfer pricing policy may enable. In most cases, the tax department is responsible for the tax management of transfer prices.

An effective tax department

The objectives of the tax department are to manage tax risks and to manage the group's overall tax charge. A balanced mission statement will mention the tax department's role as a support to the business operations of the group.

Setting up an effective tax department requires sharing objectives with and obtaining consensus between the tax function's "service delivery team" and its "customers". This involves agreeing on the definition of procedures, ensuring that these procedures are being applied and agreeing on the tax department's performance measurement.

The service delivery team of the tax department includes the tax specialists themselves as identified in the organization, the consolidation accounting team (who are information providers), and the "hidden tax function" that deals with tax matters (for example, accounting teams in subsidiaries, and strategic development teams). Customers include corporate management, head office and subsidiary finance departments, and business unit management.

The tax function can be effective only if it relies on a consensus between the delivery team and the customers of the tax department. It is essential to realize that the set-up of such an organization will affect the behaviour of both the delivery team and the customers of the tax department. Tax matters then, are no longer the sole concern of tax experts standing alone, detached from business, but are the responsibility of all interested parties so that the corporate culture includes a tax perspective. This incorporation of a tax perspective is a vital condition to defining and implementing a transfer pricing policy that corresponds to the tax objectives of the group.

Setting up an effective tax department

Setting up an effective tax department involves several stages. The outcome of each stage requires a consensus between the tax department's service delivery team and its customers.

Preliminary stage - Steering committee

The preliminary stage consists of setting up a steering committee which will be chaired by the Chief Financial Officer (CFO), the ultimate manager responsible, and will include representatives of the tax department's service delivery team and its customers. The steering committee's role is to act as a consensus tool. It is responsible for evaluating the efficiency of the tax department.

Members of the steering committee should include the head of tax, the head of consolidation, an external consultant and, representing the tax department's customers, a panel of representative managers, for example, the heads of business units and the head of development. The steering committee's tasks include the definition of the interview process required as part of the definition of the tax department and of the selection of relevant interviewees. The steering committee also validates the findings of each stage.

First stage - Validation of the needs and objectives of the tax department

Interviews enable the identification of:

- Needs and objectives of the tax department as defined by the tax department's service delivery team, such

- as the tax specialists, consolidation teams and hidden tax function
- Needs and objectives of the tax department as defined by its customers (For example, corporate management, head-office finance department and subsidiaries finance department and business units' management)

These interviews enable completion of a diagnostic. The diagnostic includes a design of the boundaries of the Minimal Tax Function, which is reviewed by the steering committee. The Minimal Tax Function varies depending on the corporate culture. It corresponds to the minimum the tax department's customers expect and the maximum the tax department's service delivery team can provide given its resource and budget allocation.

Second stage - Defining the objectives of the tax department

This stage's main objective is to define the tax department's priorities. These priorities should themselves depend on the level of tax maturity and tax management of the group and its (foreign) subsidiaries.

The objectives of the tax department may then be formalized in a quality charter provided to the tax department's service delivery team and its customers. This charter is signed by the head of tax and the finance director, approved by the steering committee.

The quality charter describes the objectives of the tax department which result from the consensus approved by the steering committee, its organization (centralized or decentralized) and its operations (rights and obligations). The quality charter is part of a continuing quality improvement process where performance is measured on the basis of the objectives of the tax department and the satisfaction of its customers. In this respect, given its nature, transfer pricing probably offers the most obvious link between the tax department and its customers. As an example, transfer pricing policy may have a direct impact on the performance measurement of the subsidiaries.

A procedures manual completes the quality charter. The procedures manual includes the objectives of the tax department, formalizes the priorities defined by the steering committee and takes into account the subsidiaries' tax maturity and tax management capabilities.

The procedure manual relies on four cornerstones:

1. Risk management

This objective includes:

- Organizing tax risk prevention. As an example, the tax department will assist in setting up risk management and prevention procedures within the subsidiaries/countries. Its role will also include performing audits to assure compliance with these procedures and harmonizing procedures within the group (notably in respect of the transfer pricing policy).
- Identifying key areas of risks. For example, a subsidiary/country tax department's responsibilities may include identifying risks with the accounting teams, audit teams and external auditors. Its responsibilities would also include quantification of those risks and feeding the reporting tools.
- Controlling/mastering risk management – as an example, the head-office tax department advises the head-office finance department on the amount of tax provision to be booked in the consolidated accounts.

2. Optimize the group's tax charge

This objective includes:

- Determining current tax rates in statutory accounts;
- Determining the consolidated effective and deferred tax rates; and
- Defining indicators as regards taxes that are not corporate income-based.

It is essential to understand these different parameters to implement and manage an optimal transfer pricing policy. Doing so requires being in a position to perform simulations on the effective tax rates.

3. Organize tax knowledge sharing

This objective includes:

- Training of the tax teams in the various countries depending upon the subsidiaries' tax maturity and tax management. In this respect, the tax department plays an important educational role with regards to transfer pricing for the group's business people. This role goes well beyond the mere preparation and circulation of procedures and documentation, but includes frequent meetings and discussion to inform the group's business people of the issues at stake, the constraints and the risks associated with tax matters in general, and with transfer pricing in particular.

- Brainstorming within the tax department to enable the identification of tax optimization strategies.
- Tax show how, which involves reporting on the performance of the tax department to both the tax department' s service delivery team and its customers.

The involvement of business people and operational teams in the definition of a transfer pricing policy should encourage the development of a tax awareness within the group. Similarly, it also encourages the grounding of the tax policies in business concepts. This is particularly important as in respect of the transfer pricing policy.

4. Performance measurement

Performance measurement should be based on the following four criteria:

- Risk management - This may consist of an annual audit of the procedures to assess compliance with those procedures and, if need be, the design and implementation of corrective measures
- The impact of tax matters on the financial performance of the group
- Tax customer satisfaction
- Knowledge sharing

Third stage – Define a communication tool

This stage involves setting up a communication tool between the group and its subsidiaries to control risk, to manage the effective tax rate and to follow up on taxes not based on corporate income.

Depending upon the management and tax objectives of the group, the communication tool may be an autonomous IT tool designed for the use of the tax department or an IT tool that supplements the consolidated reporting with a number of alternatives.

In the second case, tax reporting will be linked to the consolidated reporting and should enable an automatic link between current taxes and deferred taxes. The communication tool should allow the simulation of the financial impact of a tax optimization strategy. This tool should therefore enable the impact of a change in transfer pricing policy to be assessed.

Regardless of the tool, it should allow information to the tax department to be provided on the provision in the accounts in terms of tax risks, on the effective tax rates and enable follow-up on taxes that are not calculated in corporate income.

Fourth stage – Testing the communication tool

This stage enables a test, based on a representative sample of subsidiaries, the functioning of the tool and an assessment as to whether modifications are required. The test involves a representative sample of subsidiaries. Subsidiaries are selected to reflect various levels of maturity and the presence (or not) of an in-house tax specialist. Selected subsidiaries should also be involved in significant intra-group relationships (products and services, intangibles, financing) so that it is possible to test the impact of a change in transfer pricing policy.

The objective is to test whether the instructions contained in the manual for feeding the tax reporting are relevant and to measure the time required to treat tax-related information. At the end of this stage, it may be necessary to reshape the reporting tool.

Fifth stage – IT specifications

This stage involves setting up IT specifications for the IT teams to be in a position to adapt existing software to the specifications.

The tax department is then in a position to obtain the necessary information to assess tax risks. The tax department relies on IT tools enabling the control of the tax charge of the group through effective tax rates and indicators on other taxes.

Definition and implementation of a transfer pricing policy

The implementation of a transfer pricing policy should take into account the corporate culture and the organization of the tax function within the group. Implementing or redefining a transfer pricing policy will first require the tax function to be properly organized.

The implementation of a transfer pricing policy can not be effective unless there are procedures available to control the risks and the global tax charge of the group through indicators such as the local, global and consolidated effective tax rates.

The transfer pricing policy has a direct impact on income recognition in each jurisdiction and risks related to it (therefore the global tax charge). The transfer pricing policy may also have an impact on performance measurement mechanisms within the group. Transfer pricing includes both operational and tax considerations.

Business teams rely in the course of their day-to-day business on pre-defined transfer prices as part of their intra-group transactions. One of their main concerns is to be in position to have at their disposal a set of clearly defined rules which can be used to set the terms and conditions of their intra-group transactions.

As regards the definition of a transfer pricing policy, the objectives of the tax department are identical to its overall objectives: control/master the tax risks and the effective tax rate. In addition, management will also require that terms and conditions of intra-group transactions are consistent with the strategic objectives of the group.

Finally, recent modifications in terms of accounting norms also require increased transparency. In some countries, auditors are required to attest that transfer pricing documentation is in place.

The process of implementing an efficient transfer pricing policy

Implementing a transfer pricing policy involves five key stages.

Stage one – Data and information gathering

The objective of this stage is to collect data and information on the activities, functions, risks and assets of the transacting entities as well as the financial data required as part of the analysis. This stage involves completing:

- A value chain analysis of the industry and of the group, the objective of which is to determine the key value drivers in the business.
- A functions, risks and assets analysis grid (enabling you to perform a functional mapping of the group)
- Intra-group transactions flows (including the amounts at stake)
- The most important items of relevant segmented profit and loss statements for the key activities of the group
- The contractual arrangements relating to the intra-group flows
- Information required is generally obtained through (i) interviews with relevant managers (from businesses and from the finance departments) and (ii) information technology systems (such as databases) which enable the identification of relevant financial data. The minimal output of this stage should be a mapping of intra-group flows.

Stage two - Diagnostic

This analytical stage relies on the use of information gathered through the first stage. The objective of this stage is to define and assess what constitutes an arm's-length model for the group. This stage requires putting into perspective the value chain analysis, the nature (and significance) of intra-group relationships, the remuneration of functions, risks and assets, and the consequences of these factors on actual remuneration of the related parties. The output of this phase is a quantification of the main tax risks and the identification of areas where planning opportunities are possible. A comprehensive understanding of the value creation is essential. Transfer pricing policy must be consistent with the value chain analysis. In addition, this stage also requires the use of standard transfer pricing tools: functional, risks and assets analysis, and the economic analysis enabling to determine arm's-length conditions.

If a transfer pricing policy is already in place, the group should be in a position at the end of this phase to define key areas of risk and to identify opportunities. The conclusion of this stage includes proposals for modifying, amending and/or redefining the transfer pricing policy. The presentation of alternative policies encourages discussion and therefore facilitates the decision process. A radical change in policy may reduce tax charge risks while enabling a better control of the risks (or vice versa) but be difficult to implement. On the contrary, a mere evolution in current transfer pricing policy may be relatively easy to implement but its impact on the tax charge and tax risks could be minimal or even negative.

In the absence of transfer pricing policy, the main objective of the diagnostic is to propose various transfer pricing policies. The conclusion of this stage should also be the presentation of the basic design of different transfer pricing policies. Each proposal should include pros and cons to facilitate decision making.

Stage three – Decision process – Design of a transfer pricing policy

Issues with the current transfer pricing policy have been identified through the diagnostic and should provide managers with the necessary information to take an informed decision.

The transfer pricing policy will rely on the value chain analysis, the functioning of the group and of the subsidiaries or entities, the functional, risks and assets analysis, and the economic analysis. Based on the above, the group is in a position to define a consistent transfer pricing policy, coherent with the functioning of the group, management objectives and the arm's-length principle. Ultimately, this phase will conclude in a test of the basic design of the model enabling to assess its impact on current and consolidated effective tax rates.

Stage four - Implementation

Once the transfer pricing policy is defined, it then needs to operate properly within the group. For a transfer pricing policy to work properly, it needs to be understood, accepted and applied by all relevant parties. Implementation therefore requires that responsibilities have been clearly defined. Implementation of the transfer pricing policy will rely on a pertinent economic analysis, validated by the operations and consistent with the tax risks and tax charge objectives of the group.

This stage is undoubtedly the most important of the five phases. An improperly implemented arm's-length transfer pricing policy is unlikely to be arm's length and is inherently risky. When an arm's-length transfer pricing policy has been defined, transfer pricing risk is simply an implementation issue. Defining an organization, procedures and information systems, is the minimal investment required to implement a tax efficient transfer pricing policy.

Stage five - Documentation

Transfer pricing documentation, which combines the stages required to define the transfer pricing policy, is one of the key aspects of the management of intra-group relationships. This documentation also includes contractual documentation, such as agreements. Transfer pricing documentation is first and foremost an external communication tool which may be provided to relevant tax authorities, and an internal communication tool, since the documentation should be made available to the relevant parties involved within the group.

Transfer pricing documentation does not only involve the formalization of the above mentioned stages. Documentation should also include a value chain analysis of the industry and the group (the objective of these analyses is notably to characterize key value drivers), a functional, risks and assets analysis, and the economic analyses.

This tool should be regularly updated to take into account changes within the group and evolutions in legal requirements. Best practice requires built-in signalling of needs for maintenance and repair of the transfer pricing system and its documentation.

The above five stages should not be viewed as one-shot stages. Managing transfer price is a continuous and dynamic process.

Transfer pricing team and management of the group's tax charge

The role of the transfer pricing team is to propose solutions in respect of the global tax charge. These propositions are provided and reviewed by operations management and the group's head office management. Analytical stages required as part of any transfer pricing planning exercise (data and information gathering, and diagnostic) are the responsibility of the transfer pricing team. Analytical work will rely on resources of other departments of the group (for example, strategic management, finance team and sales team) as well as with external advisors, unless the transfer pricing team has very large resources.

Then, the transfer pricing team will participate in discussions regarding the selection of a transfer pricing policy. Its minimum involvement is that of an internal adviser, the approval of which will be systematically required for all key decisions. Finally, the transfer pricing team will also be in charge of implementing the transfer pricing policy. This task is likely to involve setting up procedures and organizing the relevant information flows.

The transfer pricing team will rely on existing reporting tools so that it can propose tax optimal transfer pricing policies after having simulated their impact.

Implementation is key

For multinational enterprises, managing transfer prices requires both the ability to implement a sustainable transfer pricing policy that satisfies the arm's-length standard and to ensure that the policy is adequately implemented. Defining precisely the responsibilities in terms of transfer prices within the tax department and within the group is critical to manage these issues successfully. Implementation of an effective tax department is an essential prerequisite to the definition of a tax efficient transfer pricing policy.

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