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# Tax Risk Management and Transfer Pricing: Practices and Evolutions

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**Abstract:** The paper deals with Transfer Pricing and investigates the policies that MNEs undertake in order to manage the related risks. The recent implementation of the BEPS framework by many States around the globe tightened controls and compliance requirements of Tax Administrations. The Authors carried out a case study involving a Multinational Enterprise located in North-West Italy in order to assess how the recent evolutions are affecting internal procedures in the organizations. The first results are consistent with the contingency theory predicted in previous literature. Moreover, the case study shows that organizations are more compliance-oriented and see Transfer Pricing Practice as an operational lever to enhance their efficiency.

**Key words:** transfer pricing; tax risk management; OECD
**JEL code:** M1

## 1. Introduction

This work deals with a topic that has constantly been under scrutiny by tax authorities, by Multinational Enterprises as well as by many Scholars between the end of the XX century and the beginning of the XXI: the so-called “Transfer Pricing”.

All of the activities related to the determination of the prices of the transactions occurring among affiliated companies (i.e., a parent company and its subsidiaries) located in different jurisdictions fall under the definition of Transfer Pricing. These transactions are intrinsically characterized by risk for misbehaviors of the Multinational Enterprises that may manipulate intercompany prices to lower the overall tax effective rate of the Group.

Moreover, these harmful practices are well-known by the tax authorities of the most developed countries that have tried to tackle them under the “arm’s length principle” OECD (2017) expressed in art. 9 of the OECD Model Convention. The Arm’s length principle provides that related companies should determine their prices as unrelated parties.

Although the arm’s length price determination has widely been accepted around the world, also in reason of the several publications of the OECD on the matter (OECD, 2010, 2017), this always comes with a degree of subjectivity that leads to uncertainty into the system.

On the one hand, tax authorities have become more sensitive on this topic, challenging the price determinations made by the Multinational Enterprises, on the other hand, Multinational groups have increased their efforts in compliance and desire to minimize the risk of negative outcomes related to transfer pricing

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assessments. Indeed, the Arm's Length principle itself has been challenged by some Authors (for example, Neto, 2019; Capristano Cardoso, 2019).

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. To do so, the Authors carried out a case study aimed at understanding internal procedures and organizational processes of Multinational Enterprises which results in useful insights for practitioners, academics and tax authorities/regulators.

As relevant literature shows, Transfer Pricing potentially arises many risks for a Multinational Organization: from a financial point of view, the negative downturns of a tax assessment may cause losses but from a reputational point of view it may also affect the public opinion affecting market shares. Thus, it is relevant to understand how Multinational Enterprises cope with these risks and what their expectation for the future is.

The remainder of this paper is structured as follows: 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.

## 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).

Recently OECD also issued the final version of the document Transfer Pricing Guidance on Financial Transactions (2020), which had already gathered attention by some Scholars (Sulejmani, 2019; S. Greil & D. Schilling, 2020).

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 the 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 & Shearon, 1996; Nichols & Conover, 2000; Bartelsman & Beetsma, 2003; Hanlon & Heitzman, 2010; Klassen et al., 2017).

Other Scholars then investigated the main determinants of transfer price changes within the organizations

(Boyns & Edwards, 1999) or price determination (Bouwens & Steens, 2016).

Lastly, a stream of Literature focused on the countermeasures adopted by different countries to deter harmful practices by Multinational Enterprises (Eldenburg & Joanne, 2003; Chan & 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 & 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 & Rohde, 2010). Other Researchers also analyzed how organizations cope with their advisers (Van der Rijt et al., 2019).

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

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 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 analyze the impact of new Accounting GAAP on comparables reliability.

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

## 3. Methodology

### 3.1 Research Design

The case study follows (Yin, 2009; 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 the understanding of real-world cases 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, a multi-level case study was adopted as a reliable method to observe real-world practices and to explore new evolutions and patterns in Organizations.

In this case, the Research Question formulated is:

RQ: How do Multinational Enterprises deal with Transfer Pricing Risk and How are organizations responding to recent evolutions in this environment? What are the main expectations about future developments on the matter?

The case study analyses a Multinational Enterprise (hereafter also “MNE” or “Group”) headquartered in Piedmont. The MNE operates into two main lines of business. The first one is represented by the manufacturing of milling types of machinery. These are highly customized to meet the customers’ needs and are mainly produced in Piedmont. The second line includes the numerical control that can be part of the milling machinery produced by MNE itself or they can be used on third party machinery.

However, one of the key success factors for the Group is the possibility to develop manufacture a milling system according to the customers’ needs, including the software/numerical control.

Lastly, maintenance activities represent an important activity to maintain customers’ loyalty.

The Group was initially founded in the 1970s and it the following two decades it had been growing steadily, opening many commercial subsidiaries around the world.

The subsidiaries were at first open in Europe as distributors and they were followed by many others in the United States of America, in South America and Asia.

As the complexity grew, it became necessary to develop also a standard transfer pricing practice for the Group: since the 1990s the Group has been facing these kinds of problems and risks which gave the entire organization a sound experience about transfer pricing. The Group also faced various tax assessments and audits on Transfer Pricing matter in different tax jurisdictions.

This fact provides remarkable material to understand different approaches that management has in discussing with different administrations.

Moreover, the structure of the Group makes rather reliable the findings of this paper: indeed, the “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.

The MNE of the case study has central R&D located in Piedmont where it also manufactures most of its machinery. Besides, some of the operations are located in China through a Joint venture.

All of the other companies are mainly involved in the distributing activity and in providing after-sale assistance, tooling up, maintenance and training to the customers.

The subsidiaries also play an important role in understanding what the customers need and helping the parent company with the design and preparation of numerical control software/devices/applications.

### 3.2 Data Collection

First of all, in order to maintain the privacy of relevant information of the Multinational Group, the Authors were asked not to publish the name on the Group. This practice is indeed rather common in case studies and surveys involving tax compliance (e.g., Plesner Rossling, 2013; Van der Rijt, 2019).

The Case Study was carried out over six months in the first half of 2019 and involved the extensive literature review in order to understand the main gaps in the actual research as well as to prepare the structured interviews that were subsequently held with the top management of the Group.

Moreover, the Authors followed up the implementation of some particular transactions related to intercompany financing activities and intangible goods in the first months of 2020.

The main interviews involved the Chief Financial Officer, who was in charge of the Group Transfer Pricing Policy and faced several audits. One of the audits was on-going at the time the Case Study was being carried out.

The Authors had then the opportunity to interview some of the members of the Board of Directors, in particular, one of them has been working for 33 years at MNEs. Moreover, this Director had the opportunity to spend most of its career managing the various subsidiaries around the globe. He had been involved many times with transfer pricing matters as he used to deal (and he still does) with commercial and distribution activities.

Lastly, the Authors had the occasion to interview the President of the Board of Directors for a short informal meeting on the topic of Transfer Pricing that, however, was very important to understand the main topics that arise major concern in the Group at the moment.

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.

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”. Also, relevant documents were shared with the authors.

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

Nevertheless, further case study carried out within different Group in order to generalize the findings or to have more field of discussion

## 4. Findings

### 4.1 Transfer Pricing Objectives

As said above, MNE has been incorporating many subsidiaries in different countries, thus different jurisdictions, over three decades. This created a solid Transfer Pricing culture within the organization, in particular at top management level.

The first analyses about Transfer Pricing were carried out when MNE incorporated the first subsidiary abroad: thus, the MNE has developed an important set of procedure in order to deal with Transfer Pricing.

In this sense, the organization focuses on a preventive approach in order to deal with Transfer Pricing rather then simply verifying at the year-end if the intercompany prices can be deemed arm’s length.

As explained by the CFO, the Parent company performs a complete revision of the Transfer Pricing policy and procedures at least every two years, while every single new transaction is evaluated if it emerges in the meantime. The parent company usually asks the various department of its subsidiaries to fill in a questionnaire in order to evaluate if major changes emerged during the years to the intercompany transactions. Every key responsible is invited to give its opinion about the transactions from which it can potentially emerge a difference or an evolution in the functional analysis.

This procedure plays a key role also for the preparation of the Transfer Pricing Documentation that MNE started to prepare 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 the Tax year 2010). However, the Documentation is still prepared with the intervention of tax consultants as *the form is still very important when MNE has to explain its transactions to the Revenue Agency or other Auditors*.

The Director underlined also that "*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 in a price similar to negotiation between independent parties*".

In addition, the main Director that the Authors interviewed indeed has been dealing with transfer pricing for over 30 years, while the CFO — part of MNE since 2014 — had previous experiences with the matter. They both have remarkable experience also about tax audits and litigations.

Each of them had an own view about Transfer Pricing practices: the Director, representing an operational point of view was mainly concerned about the economic balance of each transaction, while the CFO, representing the administrative role of the company, is concerned about the transparency of price determination process.

For these reasons, the Transfer Pricing strategy at MNE pursues two main objectives: the first one, as also the CFO commented aims at using Transfer Pricing as "the tool to reach the correct marginality in every subsidiary, which is functional to the final goal of the Group economic equilibrium". In this sense, the determination of Prices represents an operational lever to obtain efficiency.

The second one attains compliance with all of the law enforcement at a global level. This, however, CFO argued, leads to the misunderstanding about Transfer Pricing, which "often represents a compliance tool that follows the business practices".

### 4.2 Intangible goods related transactions and Financial Transactions

The transactions involving intangible assets among related parties have been gathering increasing attention by institutions and public authorities as they are deemed to play a key role in the so-called base erosion and profit shifting phenomena according to the OECD (2015).

A relevant part of the BEPS project attains the correct nexus between profit and value creation. Profit should be allocated based on the functional analysis and taking into account the entities within the Multinational Enterprise that perform Development, Enhancement, Maintenance, Protection and Exploitation of the intangible assets.

From an organizational perspective, MNE centralized the entire R&D activities in Piedmont where the Parent Company operates and has its facilities. Notwithstanding this, the Group carried out an extensive analysis to understand if there is the possibility of transferring know-how when selling the machinery to its subsidiaries. The identification of "ghost transactions" by the Italian Administration may arise litigation indeed.

However, the CFO pointed out that the analysis showed that there are no transfers of know-how in the case of sales of machinery to the subsidiaries. Indeed, the technicians involved in the tooling up of the machine are usually from the Parent company (owner of the know-how) and simply provide a service to the subsidiary. A further interesting aspect underlined by the CFO was the relation between Transfer Pricing Discipline and the Patent box regime which allows an exemption for part of the income that a taxpayer produces through the direct or indirect use of Intangible properties (or intellectual properties under L. 190/2014).

Under this regime, MNE concluded an agreement with the Revenue Agency to evaluate 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 the extensive qualitative analysis of intangible management” and it helped to bolster the overall knowledge and the consciousness of the intangible related problems related.

The CFO explained that the part of the MNE’s know-how stays with the employees. However, the overall analysis pointed out the entire process of the creation of the intangible property and that it is correctly managed. None of the employees of the subsidiaries, for example, can access the numerical control codes, which are stored in a so-called “black box.”

These analyses revealed very useful also when having to demonstrate to the Revenue Agency that there are no significant transactions related to intangible assets.

One of the most important parts of the Transfer Pricing activities indeed is the full understanding of the operational and economic structure of the Group. This activity, according to the CFO, is becoming more and more crucial as the growing compliance requirements enhance the overall transparency of the companies and therefore, offer major opportunities for litigation to the Tax Administrations.

The case study also focused on financial transactions as the OECD analyzed the main critical aspect of intercompany financial transactions in a specific working paper issued in 2018 and provided the first guidance in 2020.

The CFO pointed out in 2019 that financing activities are crucial within MNE due to the long payment conditions requested by the final customers.

For this reason in 2019 MNE tried to put in place a specific cash pooling agreement with the parent company being the cash pooler. The CFO stressed the fact that many problems emerged with the cash pooling agreements, especially due to the differences among the various jurisdictions.

For example, some of the subsidiaries non-resident in an EU Member State had to be excluded from the cash pooling agreement.

Another relevant aspect to take into account however had been the functional analysis related to the cash pooling as outlined OECD (2018 and 2020).

Indeed MNE found the definition of risks and functions related to this type of transaction more complicated than routine operations. One of the main characteristics of the cash pooling agreements indeed is that unrelated parties would not enter in such kind of agreements.

Therefore, it is rather complex finding the correct degree of remuneration for the functions performed by the cash pooler. A rather relevant problem, in addition, may arise in case the liquidity stays into the cash pool accounts for a rather long period. This may be regarded as a long-term financing activity from the Revenue agency’s perspective rather than a typical short term liquidity management.

For the remainder of the group, the problem related to eventual excess of cash were solved through the dividend payments. The CFO declared that he is currently evaluating effective policies to prevent any future challenges related to the cash pooling agreement.

### 4.3 Routine Transactions

With reference to the intercompany sales of machinery, it is worth noting that MNE usually determines prices based on a price list that is the same for all of the company. This mainly because the Transfer Pricing policy aims to maintain a certain consistency within the group as the CFO also pointed out.

Indeed he explained that part of the Transfer Pricing strategy involves “the consistency between the pricing policies with business transactionsthatis 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”.

Nonetheless this strategy presents some critical points. Indeed the margins of each transaction may vary due to specific conditions. Sometimes, also, the tax authorities may become suspicious about the different margins around the various subsidiaries.

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

Despite the standardization of the catalog that has been made among the entities of MNE, each transaction has some peculiar characteristics: each machinery indeed can be sold in different customizations to meet the customers’ needs. This may squeeze the margins related to some transactions. Also, some of the transactions may be accepted (even if accepting it may result into losses) because they are relevant from a strategic point of view.

Nonetheless, it is very hard to explain and to demonstrate this to the Tax authority: “the Parent Company, for example, may sell one of his machinery to one of the subsidiaries realizing a tiny margin. This would not probably be considered 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 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 machinery. 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 machinery and the subsidiaries that have a 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”.

**4.4 Transfer Pricing and Tax Audits**

During the period of the data collection, the company faced an audit-related to Transfer Pricing. The Transfer pricing policies proved to be rather sound, as the audit closed with minor remarks from the Revenue Agency.

The audit represented an important starting point to debate about the main concerns that MNE has related to Transfer Pricing, tax audits and future evolutions of this topic.

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 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.

The CFO was mostly concerned that a negative assessment in a country could lead to double taxation in the event that the country of the related party would not allow the subsequent adjustment.

Moreover, Director and CFO argued that the higher level of compliance requested for many different purposes is a double-edged sword: it helps the company to better understand its internal procedures and organizational structure, but it also offers many data and documents to the tax office that may not be fully aligned arising suspects and litigation with the tax authorities.

The tax auditors are increasing their competencies about transfer pricing and CFO argued that it is a positive thing, as they should be more aware of the practices as well as willing to understand the economic reasons for each transaction.

CFO also pointed out that it would be desirable for the possibility to discuss joint audits in order to reduce the risk of double taxation.

## 5. Critical Comments and Conclusions

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

From the first point of view, findings stand in line with relevant literature (Cravens, 1997; Plesner Rossing & Rohde, 2010) stating that Transfer Pricing practices are considered as an operational lever to reach higher levels of efficiency and not only as a mean to achieve un legit tax savings.

As showed by other literature (Van der Rijt et al., 2019), MNEs showed a rather high degree of knowledge sharing towards its consultants, both at an operational and a strategic level.

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

Even if the Multinational Group proved sound Transfer Pricing policies that result in minor remarks during a tax audit, some critical matters still need to be addressed.

For example, it may be rather important to cover again the transactions related to intangible goods. Revenue Agency may indeed require a specific functional analysis in the future including the so-called DEMPE analysis.

As said above, MNEs show compliance-oriented behavior: in this sense, the interviewees showed interest in the topic and willing to follow some relevant literature such as Peng and Lagarden (2019). Attention on this topic should be further stressed by Academics and by Institutions, also considered the recent debate on the matter (for example, the UK Financial Reporting Council, 2019).

The growing complexity of compliance showed the cross-contaminations and interactions of different tax measures or practices: for example, the patent box regime provided useful knowledge also for Transfer Pricing documentation and vice-versa.

This could also lead to an increase in the attention of Academics of the effects that different legislations have on the overall structure of MNEs and about the interactions among different tax provisions.

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

The case study gave also interesting material to answer the research questions: first of all, Multinational Enterprises are more and more compliance-oriented. They adopt a preventive approach, implement follow up strategies and ex-post evaluation in order to create a sound compliance system that can support the management during audits.

Also, in line with contingency theory, Management Control System adapts within 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 order to better detect risky transactions and to allow corrective measures to transfer pricing policies.

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.

This also represents a crucial topic for the analysis: understanding, if MNEs are prepared to face Joint audits, could foster the actions of Institutions (the EU for example) in accelerating the changes to local legislation.

To conclude, this work answers 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, a further case study may lead to generalizing them.

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

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