

How to tackle more transfer pricing controversy with limited resources



ISAAC SARPONG: Isaac is the Partner in charge of Tax Services. He has over 26 years' experience in the provision of multi-faceted advice to both local and international clients in taxation, accountancy, audit & assurance, and corporate law, among others. Isaac is a Chartered Accountant, a Chartered Tax Practitioner and a Lawyer.



Transfer pricing is the highest source of tax risk, surveys say. A proactive approach is best – but how do you do it with limited resources?

Two questions to ask

- ▶ How do you shift from meeting basic transfer pricing documentation requirements to providing more contextual information demanded by authorities?
- ▶ Why is a proactive approach to transfer pricing controversy effective?

Transfer pricing (TP) has again been ranked as the biggest tax risk by multinationals in EY's 2021 Tax Risk and Controversy Survey, making it the top risk category in the last four bi-annual surveys. A second EY survey, meanwhile, indicates that 80% of companies experienced challenges to their TP positions in the three years up to 2019. Against this backdrop, tax leaders are increasingly focusing on building a controversy function fit for the future where a proactive approach to TP controversy management is a key feature.

Adopting a proactive approach to TP controversy can help in identifying, managing, and resolving TP disputes more efficiently and effectively, and the resource challenges of moving toward a more proactive approach can be overcome.

What does proactivity mean in a TP controversy management context?

For many, proactivity in the TP controversy space has traditionally been limited to meeting minimum TP documentation requirements and seeking Advance Pricing Agreements (APAs) or other rulings in select situations.

Recent experience suggests, however, that tax authorities are increasingly adopting a "show, not tell" approach to TP audits, requiring both far more contextual information and greater levels of detail which may not be contained in standard compliance-oriented TP documentation.

Knowing that audit assessments are becoming more detailed, taxpayers should be asking themselves whether they are adequately prepared to quickly, confidently, and comprehensively respond when such questions are raised, and whether the design, implementation and documentation around new or revised operating models, business restructurings and supply chain configuration adequately address TP controversy risk.

Proactive approaches toward TP controversy management can include:

- ▶ Integrating a TP controversy focused workstream in tax planning, operating model design, and implementation projects, allowing the tax department to recognize risks as they arise and to properly consider and compare their options as well as to prepare supporting documentation accordingly. This should also include consideration of all available dispute resolution options, for example by identifying whether potential intercompany flows have suitable Mutual Agreement Procedure (MAP) coverage, as

well as opportunities for the strategic use of APAs.

- ▶ Creating comprehensive files of tax documentation which combine supporting material, legal opinions and arguments, and economic analyses to evidence the activities of specific entities and transactions and issue specific guidebooks that provide a framework for preparing consistent positions in support of multi-jurisdictional issues (e.g., licenses or service fees paid by various group entities to one or more central entities).
- ▶ Confirming legal documentation is sufficient by remedying any gaps in documentation and maintaining consistency with the facts on the ground and descriptions in TP reports.
- ▶ Having in place a comprehensive TP risk management framework which outlines how tax risks are to be identified, rated, reported, and escalated within the organization. These frameworks can also outline the level of support required for categories of risk (e.g. what kind of risks require independent advice or legal opinions) as well as when and how to initiate dispute prevention and resolution processes like APAs, MAPs and litigation.
- ▶ Developing and implementing an APA strategy which clearly articulates the benefits to be obtained (e.g. concluding APAs to leverage in multiple markets, ensuring certainty over important "foundational" transactions, building relationships with the competent authorities of key jurisdictions). Despite being one of the more effective proactive tools available to taxpayers, only 35% of respondents in the 2021 EY Tax Risk and Controversy survey indicated that they execute a clearly defined, proactive, well-resourced APA strategy.

Additional proactive tools and strategies are also available, such as: running analytics on tax data; monitoring controversy trends in key markets; executing a regular program of tax risk reviews; use of cooperative compliance programs; and getting involved in the design of tax policy, either directly with policymakers or through participation in industry bodies and tax forums. The last of these points can be particularly critical given today's policy is often tomorrow's controversy.

What are the benefits of a proactive approach to TP controversy management?

Properly implemented, a proactive approach to TP controversy management can mean risks are identified in real time rather than in hindsight, with disparate responses replaced by well-considered, globally consistent, and fully supported submissions.

This may reduce the resourcing burden on local tax teams and the evidentiary issues that may arise under a reactive only approach. Further, in a world with increasing levels of information sharing between tax authorities, proactive controversy management can help

taxpayers ensure they don't make inconsistent representations to different tax authorities in respect of materially identical arrangements.

Put simply, adopting a proactive TP controversy strategy can help to head off potential hazards, remedy weaknesses, and help ensure that taxpayers are defining the parameters of their own disputes.

Whilst some level of risk may always exist, the aim is to ensure that only the truly unreconcilable issues reach the point of disputes and litigation, as mistakes, negotiable positions, and peripheral risks have all either been pre-empted (controversy-focused planning), planned for (guidebooks and governance), or resolved (APAs).

How to transition from reactive to proactive TP controversy management?

While a proactive TP controversy strategy may provide a potential panacea, it can also require significant investment. The reality is that many taxpayers already face a backlog of historic controversies, including extensive information requests, multi-year TP audits, MAP cases and, of course, litigation. Breaking down the management framework into a series of incremental steps can make the transformation more manageable, impactful and sustainable – not to mention being an easier business case internally.

For example, building on work being done within existing TP audits to proactively prepare for similar scrutiny in other jurisdictions can produce key learnings to be built into future commercial structuring considerations or included in the frameworks for potential ways to manage issues and prepare responses.

By investing a little more into an on-going audit process, perhaps by including a second or third set of eyes, guidebooks can be populated, containing both TP technical and evidentiary material that ranges from benchmarking studies and successful APAs through to affidavits, personnel charts, and board minutes.

Further, guidebooks could include resources for local teams to leverage – procedural maps for dealing with information requests, standardized answers to common questions, compilations of global case law, or outlines of potential dispute resolution tools.

When resolved, why not also explore recasting or "memorializing" the audit result into an APA and securing lasting benefits? Or perhaps even consider a bilateral or multilateral APA for added security and consistency? All these potential benefits can be derived from essentially standardizing, centralizing, and leveraging work that would have already been done, thus maximizing one's time investment.

There are also numerous smaller activities which cumulatively can play a big part in reshaping the tax department's approach to TP controversy management, ranging from including a tax controversy update on the team agenda, sharing learnings between local teams, through to putting in place processes for learnings from past controversies to be

shared with core teams and considered in future structuring exercises or compliance activities. These relatively minor alterations to existing processes can create appreciable and valuable returns in the longer term.

Conclusion

The future of TP controversy is likely to be marked by the increased intensity, complexity, and multilateralism among tax authorities as governments seek to strengthen public finances in the wake of the COVID-19 pandemic and the Organisation for Economic Co-operation and Development continues to pursue its Base Erosion and Profit Shifting agenda.

Coupled with a growing trend towards these forensic, whole-value-chain focused "show, not tell" audits and an increasing use of exchange of information between revenue authorities within TP audits (as well as joint and simultaneous audits), this rapid change is driving many companies to carefully consider their approach to TP controversy.

Some level of proactivity must sit at the heart of any such redesign if it is to be successful. Whilst the tax controversy department of the future will not be one size fits all, the taxpayers best prepared to handle this ever-more globalized TP risk environment will be those able to identify what and where their risks are and how and when to resolve them.

Summary

Transfer Pricing has been the number one source of risk identified in the last four EY Tax Risk and Controversy surveys. Taking a proactive approach to managing it is important, but difficult with limited resources. What are some things you can do to keep up with rising demands for documentation and transparency from the authorities? ■

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Find out more:

Address: 60 Rangoon Lane, Cantonments City, Accra, P. O. Box KA16009, Airport, Accra, Ghana.
Telephone: +233 302 772001/772091
Email: info@gh.ey.com,
Website: ey.com