BY LEOW MUI LEE

Mitigating
Transfer Pricing Risks

In order to avoid adverse transfer pricing adjustments, the various departments within the enterprise comprising commercial operations, finance, tax, internal audit, legal and IT must work together in an integrated manner.

The introduction of transfer pricing rules and regulations in Malaysia has certainly provided much food for thought for corporate Malaysia.

For Group companies, robust transfer pricing policies need to be consistently applied and monitored to be in compliance with these rules and regulations whilst ensuring that the larger business objectives are met.

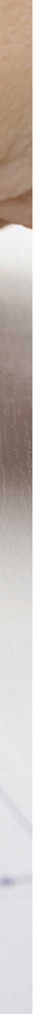
Notwithstanding the implementation of sound transfer pricing policies, the subjective nature of transfer pricing makes it open to challenges from tax authorities and the complete elimination of risks and tax exposure may be difficult to achieve.

Nonetheless, a methodical approach is essential in managing transfer pricing risks effectively.

Typically, a transfer pricing risk management system will comprise the following:

- **Planning –** The planning stage is where the Group's transfer pricing goals and objectives are formulated and the inter-company transactions identified. It also involves designing the various workflow processes such as price setting, transaction flows, etc. Roles and responsibilities are defined and communication channels identified.
- **Implementation –** This stage involves the design and implementation of a transfer pricing model by conducting a functional analysis on the enterprise taking into account assets used and identifying the key risks assumed. It also involves the selection of the appropriate transfer pricing method i.e. the Comparable Uncontrolled Price Method, the Resale Price Method, the Cost Plus Method, the Profit Split Method or the Transactional Net Margin Method. A comparability analysis is undertaken to identify comparable companies or comparable prices in determining the arm's length pricing based on the selected transfer pricing method.

The processes, which have been designed, are implemented and the stakeholders briefed on the transfer



pricing policy and the importance of transfer pricing compliance.

- **Documentation** – In this stage, the transfer pricing policies, which have been developed and implemented, are documented for purposes of compliance with the transfer pricing rules and regulations. Here, a conclusion is made as to whether the inter-company transactions meet the arm's length requirement. Additional supporting documentation such as legal contracts, supply agreements, inter-company agreements, etc. are also compiled. An audit trail detailing the decisions or judgment calls that have been made along the process is maintained and documented.
- **Monitoring** – This involves the periodic review of the relevant transfer pricing policies to ensure that they are consistent with the Group's overall business objectives as well as the prevailing regulatory environment.
- **Audit & Dispute Resolution** – This final stage involves substantiating the transfer pricing policies, which have been implemented in the event of a tax audit by the authorities. A well-planned transfer pricing policy, which is effectively implemented and meticulously documented, will ensure that the audit process causes minimal disruption to the enterprise's business.

This article focuses on the monitoring aspects in managing transfer pricing risks, a phase which is often overlooked. In a 2011 Deloitte survey on transfer pricing, it was found that over half of transfer pricing adjustments arose from inadequate implementation and monitoring of transfer pricing policies.

Transfer pricing monitoring is the process that constantly evaluates and assesses the quality and appropriateness of the various components that form the basis of the Group's transfer prices.

Key controls and processes that are identified in the implementation phase are regularly tested. The monitoring system should also define when, how and to whom internal control deficiencies should be reported.

The monitoring phase is critical in ensuring that the overall business objectives continue to be met.

For example, if the Group's objective is to have a centralised business model with a central distribution function, central purchasing function, central production function, monitoring is essential in ensuring that each enterprise within the Group undertake essentially what it is supposed to undertake in order to achieve maximum business efficiencies.

In this respect, the functions carried out must correspond to the Group's transfer pricing policies and documentation. In transactions between independent enterprises, compensation usually reflects the functions that each enterprise performs.

The assumption of greater risk demands a higher expected return. The concept is premised on the fundamental that the more one does the more compensation one should receive. An effective monitoring system must be able to identify when enterprises were to change, reduce or increase their functions thereby triggering a review of the transfer pricing policies.

The monitoring process also focuses on the accuracy of the documentation whether it relates to the Group's background, ownership structure, inter-company transactions or the transfer prices itself.

A periodic review of the actual results is vital in order to examine if these transactions meet the arm's length requirements.

Where the established margin under the transfer pricing policy was not correctly

DIAGRAM 1: STEPS IN MANAGING TRANSFER PRICING RISKS

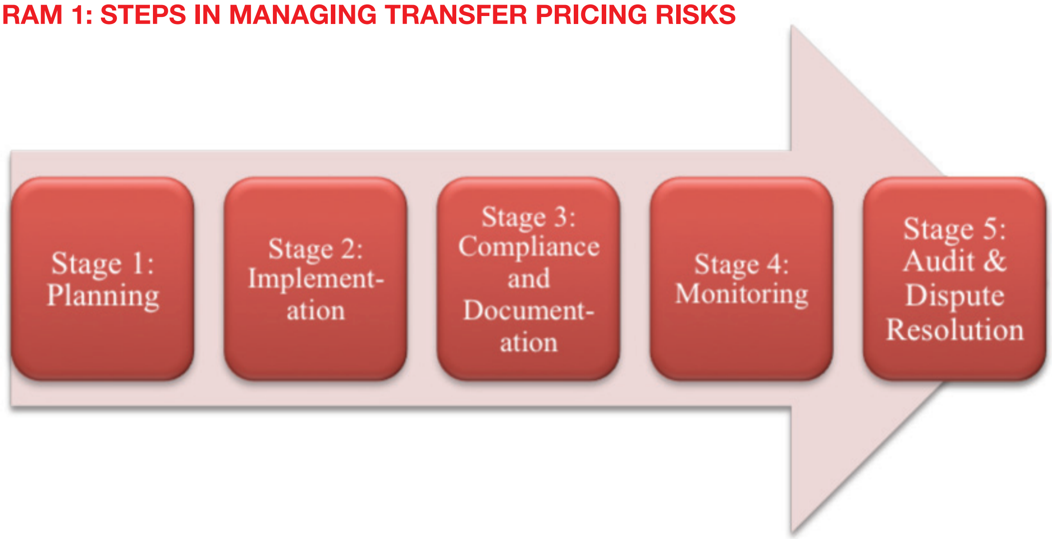
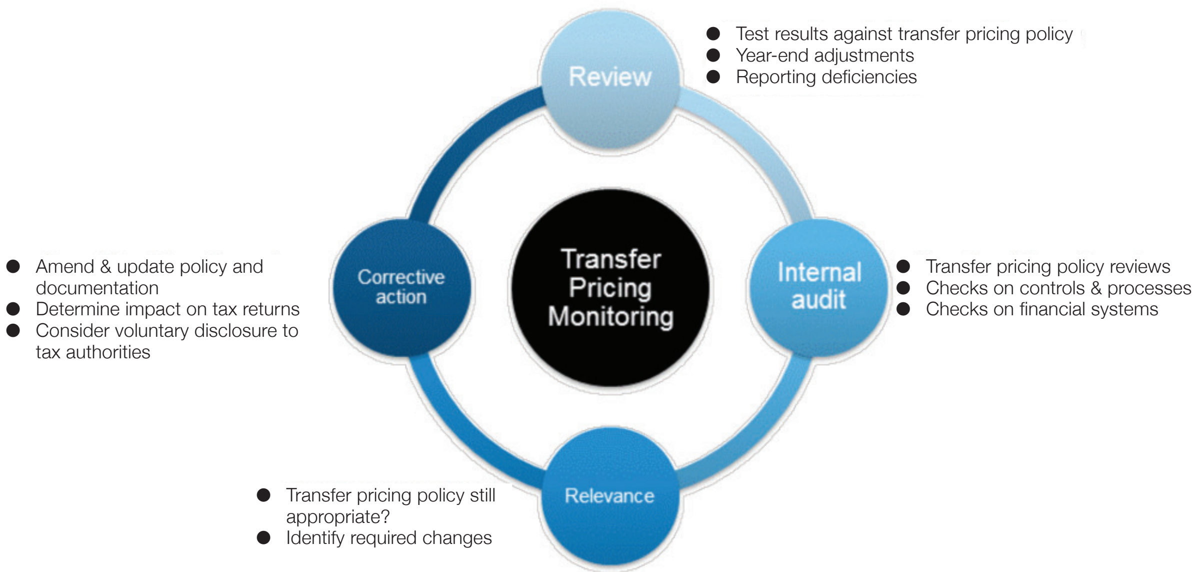


DIAGRAM 2: AN INTEGRATED APPROACH TO TRANSFER PRICING MONITORING



applied or where the policy's margin whilst accurate in the management accounts has not resulted in the target margin in the statutory accounts, the enterprise will likely face an imminent adjustment and potential penalties.

Likewise, the processes to facilitate true-up adjustments, exception findings and one-off adjustments should be evaluated. This is essential in producing tax filings, which are reflective of the agreed transfer pricing policy. It is also an important step in establishing an audit trail capable of defending the transfer pricing position in the event of a tax audit or a dispute with the tax authority.

The arm's length results of comparable companies as well as their appropriateness as 'comparables' should similarly be tested.

The evolving business environment means that the comparable companies are equally affected by economic circumstances, competition and changing consumer preferences.

So whilst the comparable may be a suitable comparison in one financial year, it may not remain so in the following years. The comparability factors (i.e. characteristics of property or services, functional analysis, contractual terms, economic circumstances and business strategies) must frequently be revisited.

In order to avoid adverse transfer pricing adjustments, the various departments within the enterprise comprising commercial operations, finance, tax, internal audit, legal and IT must work together in an integrated manner. The following questions should be considered:

- What processes are in place to ensure that the information on which your transfer pricing policies are applied is complete and accurate?
- Who is responsible for monitoring your transfer prices to ensure that your transfer pricing policies will result in the target margins achieved by comparable companies?
- Are the established transfer pricing policies being followed? Are these policies relevant in the present business environment?
- What procedures are in place to ensure that the various stakeholders understand the importance of transfer pricing with respect to your Group's compliance requirements?
- What procedures are in place to enable corrective action to be taken in order to minimise risk of penalties?
- Is the comparable data still reliable? Are there new sources of comparable data?
- Has the attitude and expectations of the tax authority changed?
- Are there any changes from a regulatory perspective, which have a direct effect on your transfer pricing policies?
- In the present climate, enquiries into the implementation of transfer pricing policies by the tax authorities more often than not will result in adjustments. In many cases, the issue is not whether the policy is arm's length but simply that the policy has not been adhered.
- Transfer pricing monitoring is therefore a vital and essential step in mitigating transfer pricing risks. It should be built in as a system of regular self-review by the Group of its compliance with the transfer pricing rules, regulations and the arm's length principle. Effective monitoring would lead to fewer surprises when the tax authorities come knocking. mb

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