



# Importance of transfer pricing implementation in a tax dispute environment

## In brief

In recent years there has been a substantial increase in the number and size of transfer pricing (TP) disputes with tax authorities worldwide. Alongside an increasing importance for taxpayers to be able to sufficiently demonstrate that they have taken reasonable care in managing their TP, tax authorities are expanding their lines of enquiry to include assessing how they implement, execute and monitor the application of their TP policies. Through adopting this forensic focus, tax authorities are commonly finding discrepancies between a taxpayer's intended TP policy and the TP outcomes following execution and, as a result, placing an onus on the taxpayer to demonstrate that they have taken reasonable care to ensure their TP policies are properly implemented and operationally effective.

This article provides an insight into how tax authorities are interrogating TP implementation along with the nature of evidence that authorities typically expect a taxpayer to retain in order to demonstrate they are taking reasonable care in executing their TP.

## In detail

### *Approach to TP assessments*

There continues to be an upward trend in the number and size of TP tax audits, assessments, and disputes by tax authorities worldwide. Such TP audits / assessments are predominantly focused on a taxpayer being required to demonstrate that the TP policies applied are in line with the arm's length principle and reflect the reality of the substance and activities on the ground, for instance:

- The intercompany transactions have been appropriately recognised;
- The operating companies have been sufficiently characterised (i.e., based on the functions performed, assets utilised and risks assumed);
- The TP method applied appropriately reflects this characterisation, substance and activity;
- Benchmarking analyses appropriately identified sufficiently comparable transactions / companies; etc.

### *A new forensic approach focussed on TP implementation and execution*

In recent years, the global trend towards the digitalisation of tax administration has led to significant investment and innovation within many tax authorities. As a result, tax authorities have become more sophisticated in their use of data and processes when undertaking their day-to-day administration of tax compliance. This increased digital sophistication has been evidenced in the 'forensic' nature of more recent TP assessments / disputes, where tax authorities have increasingly focused on how a taxpayer has implemented its TP policies.

This more recent, forensic approach means that it is extremely rare for a tax authority's TP assessment to simply end upon the review of traditional TP documentation and policies. Instead, tax authorities are increasingly concentrating their efforts into reviewing: the processes in place and data used by the taxpayer in order to execute their TP policies; and the overarching governance and controls in place to ensure TP is correctly implemented year-on-year. As a result (and combined with the evolution of local tax / TP requirements in recent years), higher thresholds have been placed on taxpayers to demonstrate that reasonable care has been taken in determining and implementing TP.

### *Recent examples of the new forensic approach*

Alongside their investment and innovation, many tax authorities have established teams of data analysts and forensics specialists which has led to a new approach in targeting taxpayers for TP tax audits. For example in the UK, HMRC's introduction of the Profit Diversion Compliance Facility (PDCF) in January 2019 has seen the use of 'big data' to profile taxpayers that have any 'hallmarks of profit diversion'. Where such hallmarks have been identified, HMRC have subsequently issued a 'nudge' letter inviting the taxpayer to join the facility or potentially face a tax investigation.

Based on our experience of assisting our clients who have been invited to join the PDCF, a number of patterns have emerged over the last 3+ years:

- Many of our clients that have been invited to join the facility appear to have UK statutory accounts, UK tax returns and CbCR data that do not fully align on the level of profitability expected of the local UK operations (or where the level of profitability is not immediately clear, especially in the context of a distributor or service provider).
- While the PDCF typically involves a deep dive into the relative value of activities between counterparties to test whether the policies are arm's length (and more generally compliance with international tax rules), a number of the conclusions reached have been that the policy applied is appropriate but incorrectly implemented. Such errors in implementation include, for example:
  - Costs / services have not been appropriately recharged, including items incorrectly excluded from the cost base; and
  - Legal entity (and branch) profit/loss statements that are difficult to segment in order to test the applicability of the TP policy relevant for a specific function / product / service.

Whilst the above patterns are specifically in reference to assisting our UK clients with the PDCF, it is important to note that such patterns - especially where a tax authority has found issues in a taxpayer's implementation of an appropriate TP policy - have been similarly experienced in the UK's wider TP audit landscape, as well as across TP tax assessments in North America, Europe and Asia Pacific. Furthermore, given the number of tax exposures that have arisen due to such implementation errors, tax authorities have been vindicated in their approach to probing systems, processes and implementation. As such, we expect this focus to continue and become business as usual for tax authorities.

### *A renewed perspective at TP documentation and evidence*

In light of tax authorities taking an increasingly forensic approach to TP implementation / execution, it is no longer sufficient to simply rely on traditional TP documentation that evidences the appropriateness of the TP policies applied. Instead, tax authorities are expecting to see additional evidence that supports whether a taxpayer has taken reasonable care in implementing / executing its TP policies. Such lines of enquiry can focus on a tax authority wanting to understand the taxpayer's:

- End-to-end process for executing its TP policies (e.g., the data used, processes undertaken and controls in place);

- Control framework that identifies and manages any inherent weak points / known risk areas (e.g., certain process / calculation steps prone to errors; key-person risk; etc), including actions undertaken to strengthen processes / correct errors and to mitigate risk in future years;
- Review and sign-off processes for its annual TP results, including who determined and signed-off on the results (including their level of seniority).

Based on our experience, the type of additional evidence a tax authority will likely request as part of this forensic approach to TP implementation includes:

- Overarching TP strategy / policy document that maps the TP policies (from that described in the traditional TP documentation) to the broad process / calculation steps implemented.
- A more detailed TP implementation / process *'manual'* outlining all data / process / calculation steps taken to implement the TP policy, including process maps by transaction type with handoffs between the taxpayer's tax team and other departments clearly identified.
- A formal governance framework explaining roles and responsibility of stakeholders throughout the execution processes, including internal controls and evidence of their effectiveness.

### *Using business transformation as a catalyst*

As well as tax authorities transforming their approach in the wake of digitalisation, many businesses are similarly undertaking business transformation projects as part of their wider investment into innovation and technology. This includes many business seeking technologically-supported solutions to help enhance process efficiency and relieve resource-restrained functions (including internal finance and tax functions). Such transformation projects present an opportunity for taxpayers to revisit the implementation and execution of their TP policies, ensuring that:

- Such TP execution processes are appropriately established and documented;
- Robust controls and monitoring procedures are put in place and can be evidenced; and
- Data sourcing / calculations are standardised and documented, including (where possible) the automation of certain calculations to help drive internal efficiencies and minimise tax risk.

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## Further information

For further information, please get in touch with our Operational Transfer Pricing team or with your usual PwC transfer pricing contact.

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