



TRANSFER PRICING COMPLIANCE: A GLOBAL FRAMEWORK FOR TRANSPARENCY AND REDUCED TAX RISKS

Introduction

With increasing globalization and expanding cross-border business activities, multinational enterprises face growing challenges in managing related-party transactions effectively, particularly in respect of transfer pricing compliance.

Transfer pricing is arguably the most relevant and challenging topic in international taxation. From an economic, business, and accounting perspective, transfer prices generally refer to the prices that are charged by individual entities (or departments) for property or services exchanged between departments of multinational enterprises or groups. The setting of these prices (that is, transfer pricing) is typically an issue that is relevant to the accounting and controlling departments of each entity operating within the group. It defines (amongst other things) the business results or profitability of the various group operations. Arguably, transfer pricing in this respect may be characterized as an assessment tool of the performance of the various cost centers, investment centers, and revenue centers of multinational enterprises.

However, transfer pricing has become increasingly relevant to taxation. This is primarily because a group has a certain degree of discretion in determining how to allocate expenses and returns to its subsidiaries and Permanent Establishments (PEs) located in different countries.



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TAX INSIGHTS – ISSUE 1

This is for management accounting and reporting purposes (that is, subsidiaries and PEs may be accounted for as standalone businesses, or they may be integrated into larger business segments or geographies). However, for tax purposes, only the statutory returns of the group's local entities and PEs are relevant as they are the starting point for calculating the tax liability of the group in the specific country in which the entities and PEs are operating.

In other words, the profitability (and the related tax liability) of subsidiaries and PEs belonging to a group highly depends on the conditions (including prices) in which these subsidiaries and PEs exchange goods and services with other entities of their group. Therefore, altering these conditions to reduce the profitability of subsidiaries and PEs located in high tax jurisdictions and to increase the profitability of subsidiaries and PEs located in low tax jurisdictions will reduce the tax burden, thereby increasing the net – that is, after tax – profits of the group. This has the direct or indirect effect of eroding the tax base of high tax jurisdictions where the economic activity occurred in favour of low tax jurisdictions where no economic activity occurred, in respect of the relevant profits.

This phenomenon is one of the main elements of 'Base Erosion and Profit Shifting (BEPS)', which typically occurs – from a transfer pricing standpoint – where the local entities and PEs reporting their profits do not perform the functions, assume the risks, and/or own the assets leading to value-creation (and the associated profitability).

To counter this phenomenon, countries around the world have introduced 'transfer pricing provisions' in their domestic tax systems that are commonly conceived as the tests or requirements in tax laws that determine the income allocation for tax purposes between the respective entities of groups.

Based on most of these rules, transactions between entities and PEs of the same group (that is, related entities) should be settled 'at arm's length' for tax purposes. The terms and conditions of transactions between related entities (that is, intra-group transactions) are defined within contracts in the case of subsidiaries and 'dealings' in the case of PEs. Transfer pricing provisions generally require that these should be accorded with those applied to similar transactions between separate and independent entities (that is, unrelated entities) in similar circumstances.

Accordingly, transfer pricing for tax purposes refers to: (i) setting prices for transactions between related entities operating in different countries; and (ii) the body of tax rules requiring that the terms and conditions of such transactions between related entities must be the same as those that would have applied between unrelated entities in similar circumstances. Compliance with transfer pricing rules is crucial to ensure that these prices reflect true market conditions according to the globally accepted arm's length principle.

The Pillar of Fair Taxation: The Arm's Length Principle

At the heart of transfer pricing compliance lies the globally recognized arm's length principle, which mandates that transactions between related parties must be priced, conditioned, and structured as if they were conducted between unrelated parties operating in similar circumstances.

This foundational conception of transfer pricing compliance, embraced by the Organization for Economic Cooperation and Development (OECD) and adopted by tax jurisdictions globally, serves as a safeguard against BEPS activities by multinationals.

Global Regulatory Landscape: Harmonization with Nuances

While the OECD's Transfer Pricing Guidelines offer a harmonized framework, countries differ in their local implementations, documentation requirements, and enforcement approaches. Almost all tax jurisdictions require detailed transfer pricing documentation, typically comprising:

- **Local File:** A comprehensive dossier detailing specific intercompany transactions, pricing methodologies, and functional analyses.
- **Master File:** An overarching document outlining the multinational group's global business operations, transfer pricing policies, and organizational structure.
- **Country-by-Country Report (CbCR):** A summary report disclosing the allocation of income, taxes paid, and economic activity by tax jurisdiction, mandated for large multinational groups exceeding certain revenue thresholds.

These requirements ensure fiscal transparency and enable tax authorities to assess whether reported transfer prices align with market conditions.

TAX INSIGHTS – ISSUE 1

Challenges in Compliance

The path to transfer pricing compliance is often fraught with challenges. Multinational companies must navigate: (i) divergent local regulations and expectations that require tailored approaches in each jurisdiction; (ii) the complexity of multi-layered transactions involving goods, services, financing, and intellectual property; (iii) frequent regulatory updates, necessitating continuous monitoring and adaptation; and (iv) increased scrutiny from tax authorities, driven by heightened focus on fiscal transparency and anti-avoidance measures.

Best Practices: Building a Robust Compliance Framework

To thrive in this environment, businesses should adopt best practices, including: (i) rigorous application of OECD guidelines combined with local regulatory insights; (ii) detailed functional and economic analyses to accurately identify risks and value drivers; (iii) proactive and ongoing documentation reviews to reflect evolving business models and legal changes; (iv) engagement with specialized transfer pricing advisors possessing cross-border expertise; and (v) maintaining open lines of communication with tax authorities to foster cooperative relationships.

Conclusion

Transfer pricing compliance remains a continuous challenge for multinational enterprises but also provides an opportunity for enhancing fiscal transparency and sound corporate governance. By adhering to local and international laws and preparing accurate documentation, companies can reduce tax risks, avoid tax disputes, and support stable and sustainable growth in global markets.

Disclaimer

This commentary is not legal or tax advice to readers. Taxpayers and businesses should consult their legal and tax advisors for specific advice regarding their transactions and businesses, including compliance requirements and recourse available to them against tax authorities.

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