How to Manage Transfer Pricing Risks

Significant tax risks in any company often derive from transfer pricing. If such risks materialize, companies can be confronted with income adjustments and possible significant cash-outs related to additional tax payments.

What are we talking about?

Transfer pricing is under ever more scrutiny from tax authorities around the world. New and further tightened regulations and legislations combined with the need for more tax revenues to cover the states' support to the economies do continuously enhance such developments. As a result, companies are often confronted in tax audits with propositions for income adjustments, which can result in additional tax payments. As an example, in April 2010, the Danish tax authorities SKAT announced transfer pricing adjustments of DKK 15.3 billion (EUR 2.1 billion) for 2009!

And even if tax risks do not materialize, companies might be obliged to book respective reserves, which burden the P&L. New developments under various accounting principles for the recognition of uncertain tax positions (e.g. FIN48 under US-GAAP) intensify these requirements.

Know your risks

It is important to know the existing transfer pricing risks in oder to be able to actively decide how to deal with them. Nothing is worse than risks materializing that were not even identified before. But how to be alert of potential risks early enough to subsequently undertake the necessary steps to mitigate or reduce the exposures?

Manage your risks

Reasonable transfer pricing risk management follows the common logic of any risk management which addresses constant monitoring of significant and material risks.

However, successful transfer pricing risk management and in particular the identification of risks depends a lot on experience out of many tax and transfer pricing audits of companies in various countries and industries. KPMG has such experience and supports you in addressing and managing your transfer pricing risks in a solid way.

1) Identification of the risks

To be in a position to actively manage the risks, it is important that the main risk areas are known and specific risks are identified. This process involves an analysis of the current TP system to evaluate where the company is exposed to uncertainties and potential dangers, e.g. via a "Status Quo Analysis". The following list includes transfer pricing risks that we commonly observe in many groups:

- Reality deviates from intra-group contracts, e.g. with respect to actual risk allocation (Substance over Form Principle violated);
- Transfer pricing documentation not sufficient or insufficient for local purposes;
- Certain intra-group transactions have developed that are not dealt with from a TP perspective at all; and
- Business restructurings have taken place without recognition as such and without analyzing the potential impact on the transfer pricing side.

2) Assessment and prioritization of the identified risks

Key to a decision which action to take is an evaluation of the risk. This allows for concentrating the resources on those risks that are actually material to the group.

The outcome of the risk assessment is therefore a clearly prioritized issue list that also determines who to address what issue where and how, and even more important until when!