

How leaning into
transfer pricing
transformation helps
manage tax risk



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Summary

Global tax reform marches on with new developments and daily challenges. Supply chains are under strain and continue to shift from long and lean to agile and resilient. Digital business models, working-from-anywhere trends and the rise of distributed hub models raise new tax issues around permanent establishment (PE), economic substance and profit allocation. Regulatory, policy and enforcement change also add uncertainty and reduce the ability to rely on the past to predict the future.

These are some of the many challenges facing transfer pricing (TP) professionals, according to respondents to the biennial 2021 EY International Tax and Transfer Pricing survey, which interviewed 979 transfer pricing professionals in 53 jurisdictions across 25 industries. Below the surface, the interactions between four key megatrends are driving what is likely to become an era of nearly constant change in TP strategy and operations.

The four forces are:

- ▶ Global tax reform
- ▶ Global supply chain reconfiguration
- ▶ The rise of controversy and changes in enforcement behavior
- ▶ Digital transformation

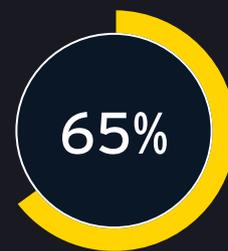
Shifting government policies and a more robust enforcement posture are driving TP risk: 65% of survey respondents say they expect the number of TP audits to rise in the next three years, and 78% identify tax risk management as the most important factor driving changes to their TP model, processes and governance.

Addressing change of this magnitude is a major ambition for most businesses participating in the latest survey as 62% of them say they have fewer than 11 people dedicated to handling TP matters. Yet, 61% of them say they will likely act to modify their organization's approach to TP plus their operations, compliance and documentation within the next two years.

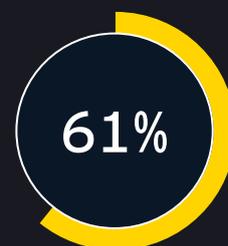
"We see major forces combining that are going to impact transfer pricing in very real, immediate and significant ways," says Tracee Fultz, EY Global Transfer Pricing Leader. "Businesses know they have to make this function more agile, adaptable and resilient so that they can avoid the wave of uncertainty and controversy that may follow - and be in a better position to manage disputes that do arise."



Jeffrey Michalak
EY Global International Tax and
Transaction Services Leader



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1

How changing laws
and regulations are
disrupting TP



Nearly two-thirds of respondents expect more TP audits – especially those with fewer resources.

External change is everywhere. Businesses are exploring novel supply chain solutions and embracing digital transformation. Tax regulatory and policy changes are happening at a record speed, challenging tax departments to keep pace with business so they can align and defend their supply chain structures as well as keep pace with the changing tax environment overall.

More than three in four survey respondents (76%) say they are being challenged by the sheer volume, pace and complexity of global tax reforms. Seventy-one percent add that tax reform is increasing TP-related costs for their organizations with 30% saying costs will increase by at least 10%. Moreover, 58% see new or evolving legislation as a top (25%), second (20%) or third (13%) most critical contributor to TP risk.

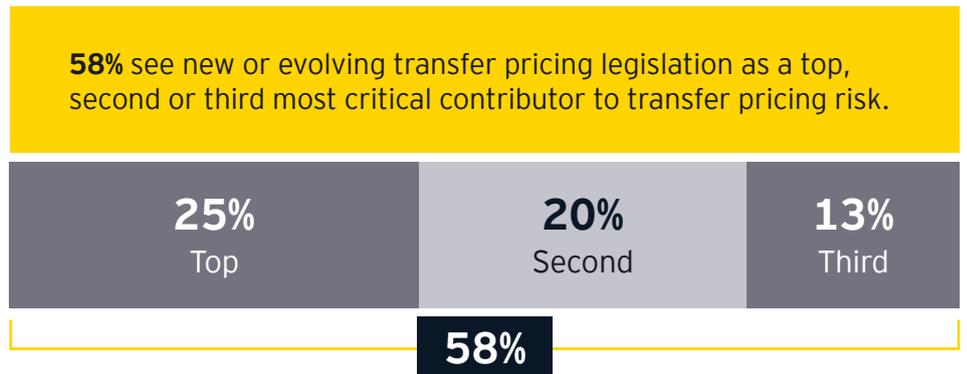
“What we are seeing today is the most fundamental international tax reform ever,” says Oliver Wehnert, EY Germany International Tax and Transaction Services

Co-Leader. “OECD BEPS 1.0 and 2.0, with its Pillars 1 and 2, are dominating the agenda. Pillar 1 focuses on shifting profits to market countries. Pillar 2 is, among other things, driving discussions around a global minimum tax, which the G-7 [Group of Seven leading industrial nations] has already agreed should be at least 15%.”

Tax reform driven by the Organisation for Economic Co-operation and Development (OECD) Base Erosion and Profit Shifting (BEPS) framework is advancing “because it really is based on what seems to be a kind of a global consensus,” continues Wehnert.

“The Inclusive Framework comprises 140 countries - and all are working towards greater alignment and consistency in the international tax framework.”

These elements - and many others - represent profound shifts. Even so, Wehnert suggests companies should be supportive of efforts to harmonize global tax rules. “What we don’t want to see is every region or country in the world writing its own rules based on inconsistent principles,” says Wehnert. “That and the consequences of double taxation would be much worse.”



Early movers

However, some countries are not waiting for the principles to reach a point of global consensus, adding risk and complexity to the overall environment. Even before BEPS 2.0 is concluded, “we’re seeing countries moving with different timeframes in terms of unilateral measures designed to perform the same kind of role,” says Luis Coronado, EY Global Tax Controversy Leader. “That’s causing new disputes to occur, as companies try and deal with a plethora of disparate measures in advance of wholesale changes.”

Jay Camillo, EY Global Operating Model Effectiveness Leader, agrees, particularly

regarding the US. “No doubt, there is strong overlap between what’s proposed by the Biden Administration and the global philosophy coming from the OECD.” Which, Camillo says, is probably “by design - I think this is an obvious, across-the-board move by the US toward greater multilateralism.”

Camillo says he believes the Biden Administration’s tax policies exhibit “broad continuity with many of the proposals within BEPS 2.0, Pillar 2 in particular.” This includes the minimum tax of at least 15% that G-7 countries are calling for and encouraging 140 countries

participating in a broader initiative by the G-20 to support.

“If a global minimum tax is adopted, there will be a fundamental shift where the predominant question becomes not if or where the profits are taxed but how much tax is paid,” says Camillo. This shift places a heavy burden on tax departments to manage their double taxation profile, which ultimately means, Camillo believes, “that they must be joined at the hip with the business, documenting operating model evolution in real-time and having data readily available on audit.”

2

Businesses rethink and reconfigure their global supply chains

COVID-19 is just the latest disruption – and businesses are still wrestling with the tax impacts.

“Companies worldwide are revisiting the fundamentals of their supply chains,” says Edvard Rinck, EY Asia-Pacific Operating Model Effectiveness Leader. “For decades, companies have been building long, linear and lean global supply chains. But starting around 10 years ago, companies began to reconsider those ideas.”

Even if the cost is greater, sometimes it's better, certainly less risky, to keep supplies closer to operations and customers, and to maintain redundancy of suppliers and increase inventories. Undoubtedly, the supply chain disruption wrought by COVID-19 is accelerating this trend.

But as Rinck explains, “The fundamental shift toward greater agility, flexibility and resilience within supply chains

was gathering momentum well before COVID-19.” Specifically, he points to other international events, such as the earthquake and tsunami in Japan and flooding in Thailand, both in 2011, as well as port strikes on the West Coast of the US.

More recently, “we saw the disruptions driven by the Trump Administration's tariffs and the ongoing trade negotiations with China that have continued under the Biden Administration. There was a renegotiation of NAFTA and then tariffs vis-a-vis the European Union (EU) for steel and aluminum. And the pandemic is high on the supply chain agenda, but it's fighting for parity with a lot of other pre-existing conditions.”

“

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Learning from disruption

COVID-19 is indeed a powerful catalyst as its disruption exposed key risks in long, lean supply chains - disruptions that survey respondents say they expect for at least the next two years. Travis Qiu, EY Greater China Transfer Pricing Leader, says global tax reform will also be a powerful, if less obvious, driver of supply chain reconfiguration. Global minimum taxes, substance rules, profit allocation to source markets: these and related elements within BEPS and related legislation reduce the benefits of an extended supply chain based on low costs and high volume.

“In the short term, it's all about business continuity - just keeping things running,” says Qiu. But, he continues, people are now asking, “How do we learn from all

of this disruption and what do we need to do to prioritize resilience over the cost dimension?” Going forward, “you're going to have companies building greater flexibility using multiple suppliers and even multiple manufacturing sites. You'll see people using digital twins to better evaluate their options, and through it all you will see much more of the supply chain reorienting around these changes, the business itself and its customers. Everything that we see in global supply chains points to more regional and fewer decentralized supply chain models.”

The rise of environmental, social and governance (ESG) reporting is also creating pressure for reforms. As Nick Muhlemann, a partner with Ernst & Young Solutions

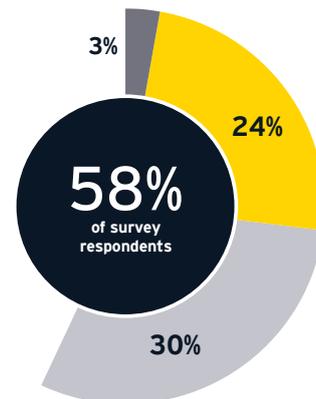
LLP in Singapore, who works on operating model effectiveness, explains, “Making tons and tons of units as standardized as possible packaged for maximum efficiency in container volume to get the cheapest landed cost after shipping over very long distances: that leaves a hefty carbon footprint.”

“While ESG issues are garnering greater concern worldwide, evidence shows they are already exerting a powerful influence over supply chains for the EU. For example, Germany has just enacted a law that will hold businesses accountable for human rights, environmental or similar infractions across their supply chain,” he says.

As businesses evolve, so must TP. Here, the survey shows that over the next three years, C-suite executives believe changes to their business model (59%), supply chain (46%), work-from-anywhere practices (56%) and ESG pressures (53%) will have an “extremely high” or “high” impact on their approach to TP. Amid so many moving parts, Rinck believes “there has never been a time when it was more important for the TP team to be engaged with the business.”

The survey results, however, show that 58% of survey respondents say they are either not at all involved (3%), involved in some but not all (24%) or involved only on a reactionary basis (30%) in key business decision-making. Interestingly,

of C-suite executives taking the survey, those percentages were 2%, 15%, and 29%, respectively. Overall, 55% of C-suite executives reported their TP functions were “generally involved in all decisions, and from the start” compared to just 42% of TP executives who said the same thing. The way the world is evolving, says Rinck, “this is a gap that has to close.”



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Working from anywhere

It's not just supply chains that are being reconfigured. The workplace itself is, too. Thanks largely to the pandemic, the trend toward working from anywhere - the workplace of the future - has accelerated from concept to practice. Recall that a driving principle within global tax reform is that income recognition is aligning with physical presence. What it means for TP in the BEPS era is that where people work matters - enormously.

Alessia-Maureen Dickler, EY Germany TP Leader, says “with the pandemic, everyone, myself included, is operating from their home offices.” Initially, this was a requirement - amid lockdowns there was no other way to conduct business. “But now, not only is this becoming the norm, the workforce expects this and, in fact, it is being promoted by companies as a way to attract talent.”

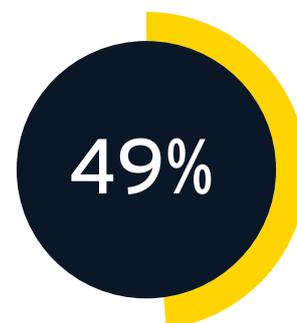
The problem, however, “is that where your people work and reside raises a number of potential complex issues,” says Dickler. In particular, highly compensated/high-value personnel, likely hired in decision-making, risk management or other key roles, create challenges for TP. “These workers make important decisions, which creates value, so where they

work is of great importance. Permanent establishment and substance drive profit allocation, but where staff is located also raises questions for value-added taxation and personal taxation that all must be considered,” says Dickler.

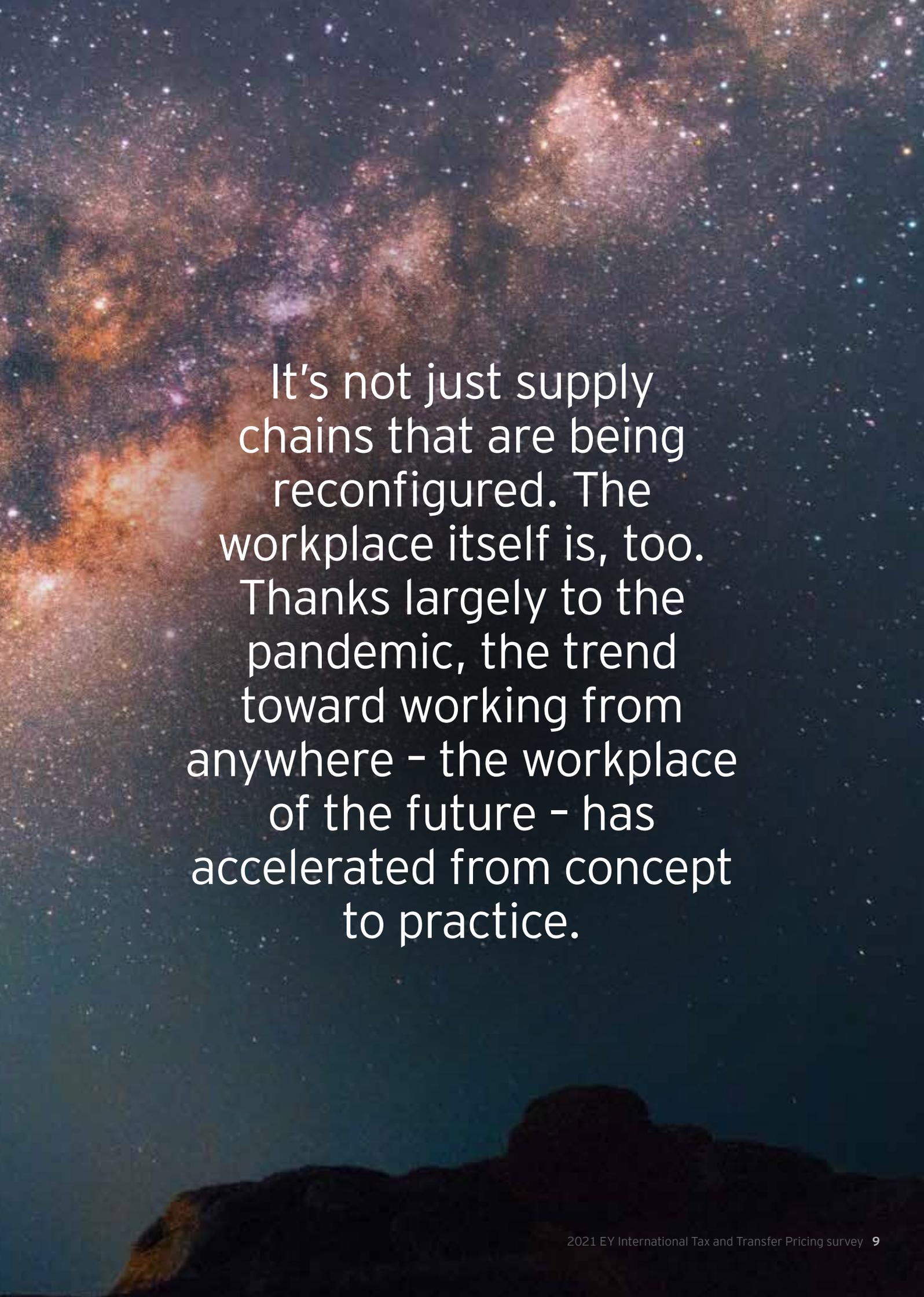
Indeed, 47% of survey respondents say they now face - and 49% say they anticipate facing over the next two years - “impact from workers and/or executives being stranded in a jurisdiction other than the jurisdiction of their full-time employment.” Of course, the work-from-anywhere era can also be a source of agility and flexibility. Currently, 75% of survey respondents say they face significant challenges in securing sufficient TP talent. Here, technologies that enable remote collaboration can help these executives cast a wider geographic net.

While virtual and highly mobile workforces and management structures introduce agility, they also add to complexity and risk. The degree to which digitally transformed businesses are creating intellectual property (IP) on a decentralized basis is yet another concern.

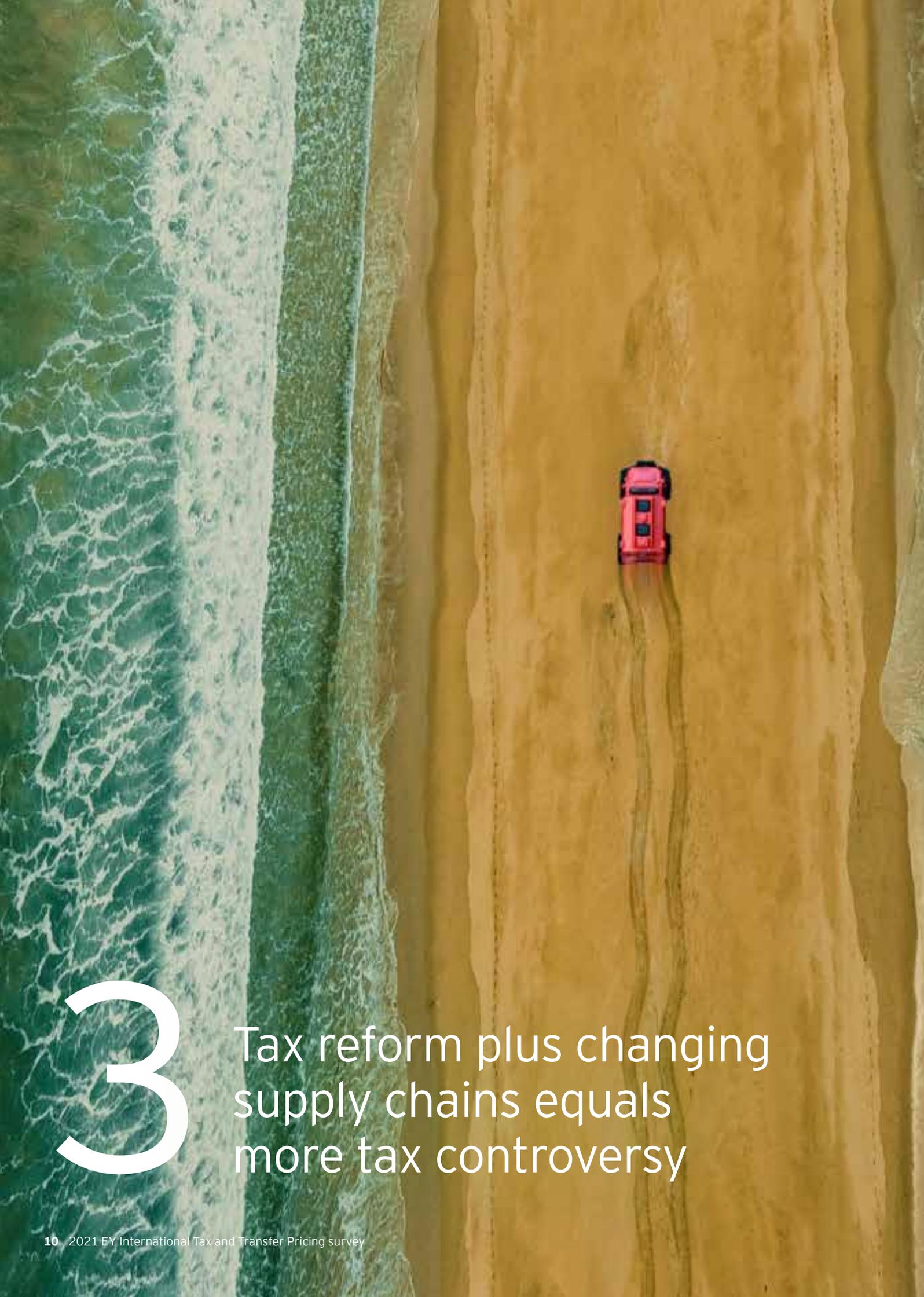
Wehnert says an increase in digital innovation is creating new challenges for cross-border enterprises. “Businesses are transforming, and when everyone is working digitally, we are seeing people being innovative, creating new digital services for their customers or digitizing supply chain processes,” he says. “For a lot of companies, and particularly those that are not really technology companies, they may not have the relevant experience, and they are losing control over their IP processes.”



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3

Tax reform plus changing supply chains equals more tax controversy

Sixty-five percent of respondents expect more TP audits, led by disputes over IP and PE.

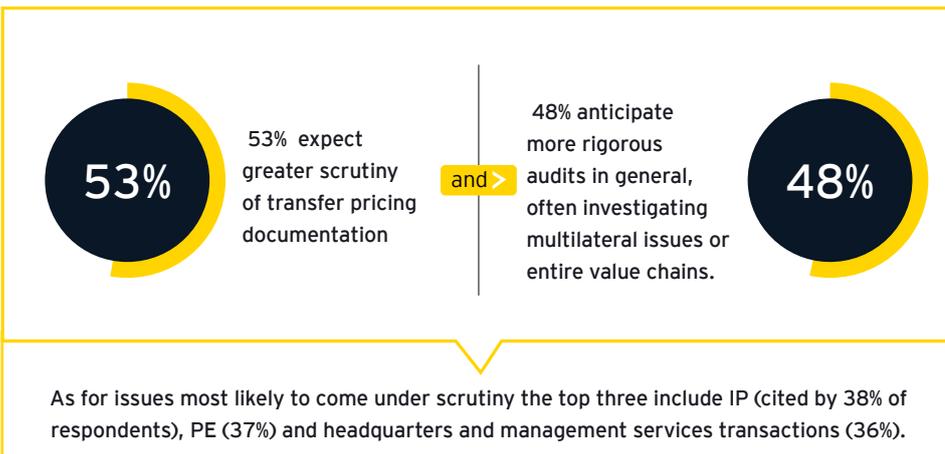
Against this background of rapidly changing tax rules, tectonic shifts in supply chain configuration and fundamental changes how - and where - people work, so too emerges a more robust and assertive tax enforcement environment. Fundamentally, in addition to mandating more transparency - and using it - tax authorities are now cooperating

with one another across borders. Increasingly, companies can expect joint or even multilateral audits.

Meanwhile, following nearly two years of lockdowns and accompanying stimulus and support spending, most nations will be even hungrier for revenue than usual. Consequently, says Coronado, "we are

seeing expanded funding giving many tax administrations more resources for the pursuit of audits."

Survey respondents in fact are anticipating an era of more frequent and rigorous audits. In addition to the 65% of respondents who expect that the number of TP audits will rise, 53% expect greater scrutiny of documentation and 48% anticipate more rigorous audits in general, often investigating multilateral issues or entire value chains. As for issues most likely to come under scrutiny, the top three include IP-related issues - location and ownership of assets, control of risk (cited by 38% of respondents), PE (37%) and headquarters and management services transactions (36%). Perhaps even more challenging than the sheer increase in volume of audit activity are the changes in enforcement approach and in the level of information tax authorities are requiring companies to disclose.



Heightened transparency and changing enforcement strategies

"Taxpayers today are now exposed to unprecedented levels of transparency," Coronado says. "Country-by-country reports and TP master and local files, supplemented with a range of new and evolving national requirements and then coupled with the automatic exchange of taxpayer information, are providing tax authorities with new ways to complement the more subjective scrutiny of their tax auditors." Audits themselves are becoming more detailed, and, increasingly, jurisdictions can be expected to begin issuing automatic assessments, leaving the burden of proof on the taxpayer to demonstrate otherwise.

Next, authorities are beginning to challenge core business decisions. "In the Tax Cuts and Jobs Act, the Internal Revenue Service (IRS) can analyze arm's-length pricing vs. alternatives realistically available," says Camillo. "They're looking closely into business structures, business relationships and other choices made by taxpayers through the lens of what options did they have available? What were the competing predictions for how those business arrangements would turn out?"

Then very importantly, "what are the differences in any of the risks being borne by either party under the various

alternatives?" says Camillo. "They look at licensing, cost sharing and other alternatives and ask why not one over another?"

This leads to companies starting to consider a range of forecasts with a range of potential outcomes, not just the most probable one. "You have to prove how reasonable businesspeople would evaluate the potential outcomes of a business relationship, proposal or arrangement with a particular emphasis and focus on risks," Fultz says.

In Europe and elsewhere

Looking worldwide, “tax authorities are under urgent pressure to collect more tax,” says Coronado. The solution, says Coronado, is a more rigorous approach to tax risk management. “Principle should always prevail. In an era of more forensic, detailed audits, companies need to be proactive around TP audit readiness, taking into account not only the new types of evidence they need to present, but also understanding what new tactics they may face from auditors.”

Overall, Camillo, Wehnert, Fultz and Coronado all agree: the future is one of significantly more frequent and intensive audits and controversy.

Going forward, “though there seems general agreement on the direction, as more and more jurisdictions write more and more legislation, there are no guarantees there will be uniformity,” says Jan Bode, EY Europe West Transfer Pricing Leader. “There is a lot of change, a lot of complexity, and it all leads to greater risk.”

For these reasons, Coronado and Bode both say they are seeing renewed interest in tools such as advanced pricing agreements (APAs) – unilateral and multilateral – as well as in programs such as the OECD’s International Compliance Assurance Program (ICAP).

In general, says Coronado, “we think you’ve got to start thinking about taking action earlier in the life cycle of controversy. That means looking across governance, teaming, controls and processes, as well as more extensive use of dispute prevention and resolution programs. That means looking at your data, your people and your processes, figuring out now whether improvements are needed in order to be fit for purpose.” He continues, “Look at your tax risk assessment and look at your management of those risks, and then your dispute management and litigation procedures also. Overall, we think right now is your opportunity to prioritize and reimagine your overall tax controversy approach.”

With 56% of companies taking a minimum compliance approach to TP documentation and 35% of companies taking a shared controversy responsibility approach between local and HQ, the gap between the need for a consistent tax authority approach and decentralization will also need to be filled.

The survey does not provide evidence that companies have digested how they will fill their resourcing and process-related gaps necessary to deal with the amount of change and run side by side with the business. Amid rising complexity, 50% anticipate higher budgets for their increasing TP activities, but only marginally so. Current plans for spending on TP are likely not enough without companies taking on additional risk. Transfer pricing enforcement is evolving to become more active. With tax controversy on the rise, alignment with the business will be essential to a tax department building sustainable and flexible operating models that can be understood by tax authorities.

Forging a response

Joel Cooper, EY Global International Tax and Transaction Services Controversy Leader, also predicts an era of significantly more controversy ahead. “Controversy will definitely expand. The frequency of controversy will increase, as will the breadth and depth and the expectations and requirements from authorities,” he says.

In fact, 56% of participants believe there is heightened uncertainty in TP, creating an unstable environment and decreasing the ability to depend on past settlements and court cases for current enforcement guidance. With over 50% of respondents still relying on their past experiences to assess TP risk, there is a greater need to understand how TP audits are resolved currently and what is being required.

“Audits will become longer and more demanding. Information requests are wide in scope, and authorities will be accessing all the information you can imagine,” says Cooper. “From social media to filings with other countries, tax authorities will want to use it all. Moreover, as this evidence-based

approach to audits expands, increasingly we see a push from tax authorities to move to show, not tell.” And sometimes, requested information is in addition to specific items listed for disclosure by the OECD.

In particular, Mikael Hall, EY UK & Ireland Transfer Pricing Leader, sees national tax jurisdictions “beginning to look into entire value chains across corporate and national boundaries. They’ll look at customs duties and R&D filings to see how these mesh with your transfer pricing reporting. They’ll look at your global and regional profitability and any rulings and positions taken in other countries, and they’re going to be looking to see where there’s inconsistencies.” In fact, companies registered tax authority data analytics, information sharing and volume of audits as the largest issues in controversy management.

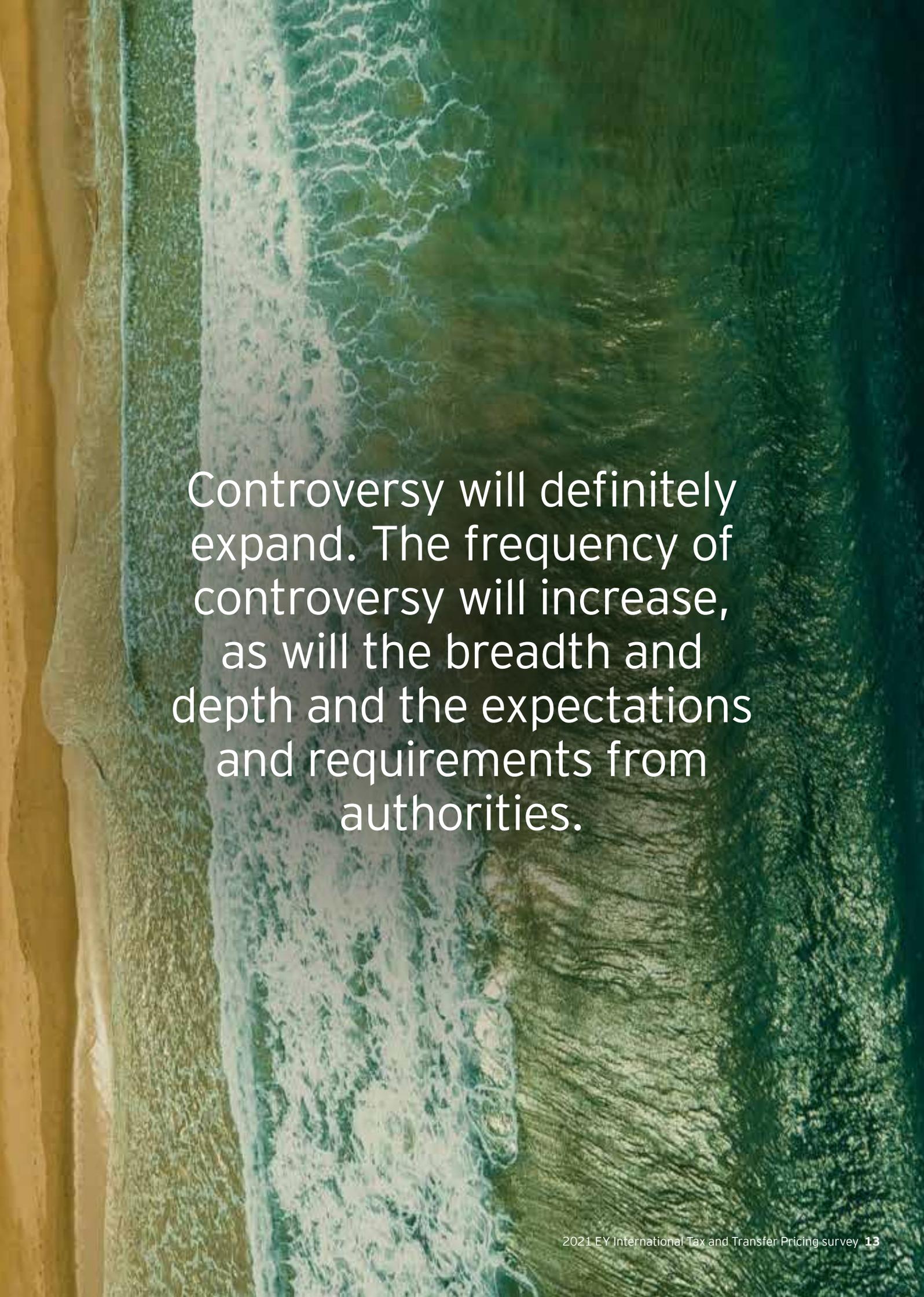
For TP executives, “they’re going to need to become more proactive in controversy management. And to do that, they’re going to have to do all they can to streamline, simplify and automate their work so their

resources can focus more [acutely] on controversy preparedness and response.”

In addition, Cooper believes more companies will seek greater assurance through tools such as bilateral and multilateral APAs or even the ICAP and will more proactively (and more regularly) seek to resolve double taxation through the use of the mutual agreement procedure (MAP).

“My feeling is that with the risk of controversy on the rise, we’re going to see more companies seeking more assurance,” says Cooper. “And so we’re also going to see more companies using these tools to reduce their risks and avoid double taxation.”

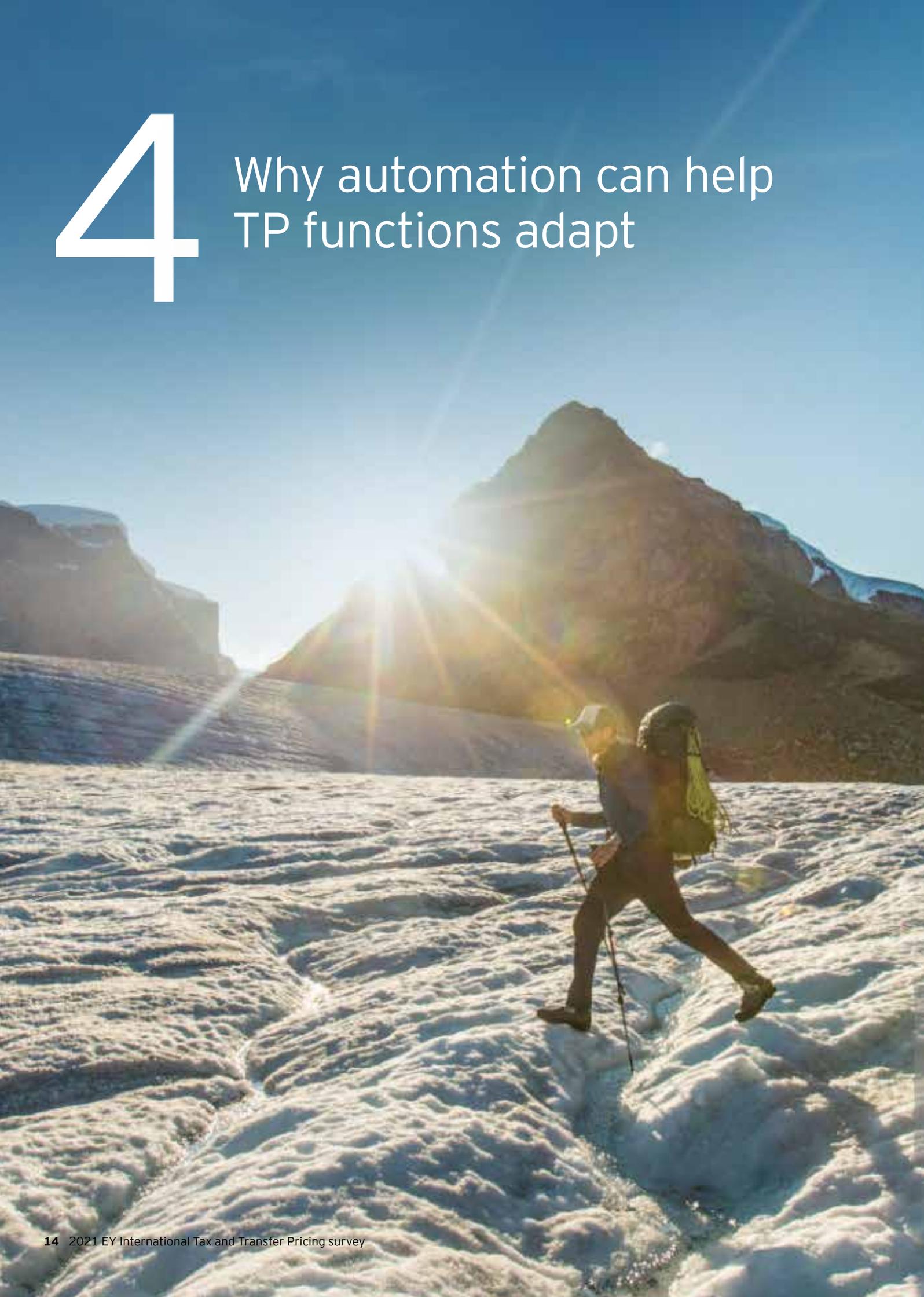
Interestingly, businesses with the largest TP departments (30 or more dedicated people) said the number one trend they see in the marketplace is significant improvement in TP dispute resolution processes. Among smaller departments, this trend ranked lower.

An aerial photograph of a coastline. The left side shows a sandy beach with some driftwood. The ocean is a deep green color, with white foam from waves crashing onto the shore. The text is overlaid on the right side of the image.

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4

Why automation can help TP functions adapt



Digital transformation can change intercompany processes to reallocate people to higher-value tasks.

“

So much of the work is manual, combing through multiple spreadsheets and other disparate sources of data

Robbert Kaufman
EY Americas Intercompany Effectiveness Leader

Digital transformation is reshaping every facet of business with the aim to become more effective and efficient. Various technologies are enabling businesses to both streamline and revolutionize business processes, sometimes disrupting entire industries.

Nonetheless, the survey shows that when it comes to TP, companies are proving slow to align technologies to pain points. For example, 72% of companies find their data collection process to be challenging, involving multiple IT systems, and 76% say such matters are riddled with quality issues. But significantly fewer companies were trying to apply tools in this area.

Instead, tools are more likely applied for data and information storage and process management.

“One thing I believe we can all acknowledge is that today, so much of what we’re doing TP is compartmentalized. Transfer pricing planning, operationalization, documentation and controversy – they’re each working in relative silos,” says Katherine Pinzon, EY Americas Transfer Pricing Leader.

Robbert Kaufman, EY Americas Intercompany Effectiveness Leader, agrees. “So much of the work is manual, combing through multiple spreadsheets and other disparate sources of data,” he says. “And there seems to be a lack of integration with other functional areas that impact or are impacted by TP, such as supply chain, treasury and finance.”

As Muhlemann says, “Companies are still thinking about intercompany as a step-by-step process instead of end-to-end.” But at the same time, most businesses have an ongoing digital transformation agenda. “There’s a full spectrum of technology available now that can be put to work right away to lighten the load and improve quality across the whole of TP,” Muhlemann says. With all of the pressures TP teams are feeling, “executives need to get involved as early and as deeply as possible in digital transformations to embed their processes and incorporate their requirements around data, automation and reporting.”

Cornelia Wolff, EY Global International Tax and Transaction Services Technology and Transformation Leader, also advises that TP executives do all they can to get involved in any enterprise resource planning (ERP) initiatives such as a migration from legacy SAP ERP systems to SAP S/4HANA. Done correctly, Wolff says, “you will be able to embed all of your data and processes end-to-end and ensure alignment with supply chain and finance.”

Another technology-enabled means of doing more with less is to explore opportunities in outsourcing and co-sourcing. “There is tremendous value in working with external providers,” says Kaufman. “As controversies multiply and become more complex, TP teams need to off-load as much of the routine workload as possible so they can focus on higher-value-added issues such as audit preparedness and response.” Kaufman adds that outsourcing and co-sourcing “become an essential means of bringing greater agility, flexibility and focus into the TP mission.”

A key solution to keeping pace with rising workloads resulting from controversy and business change lies embedded in one of the megatrends itself. Digital transformation is indeed reshaping every facet of business. But this same digitalization can be harnessed in ways that address TP’s need to become more efficient and focused.

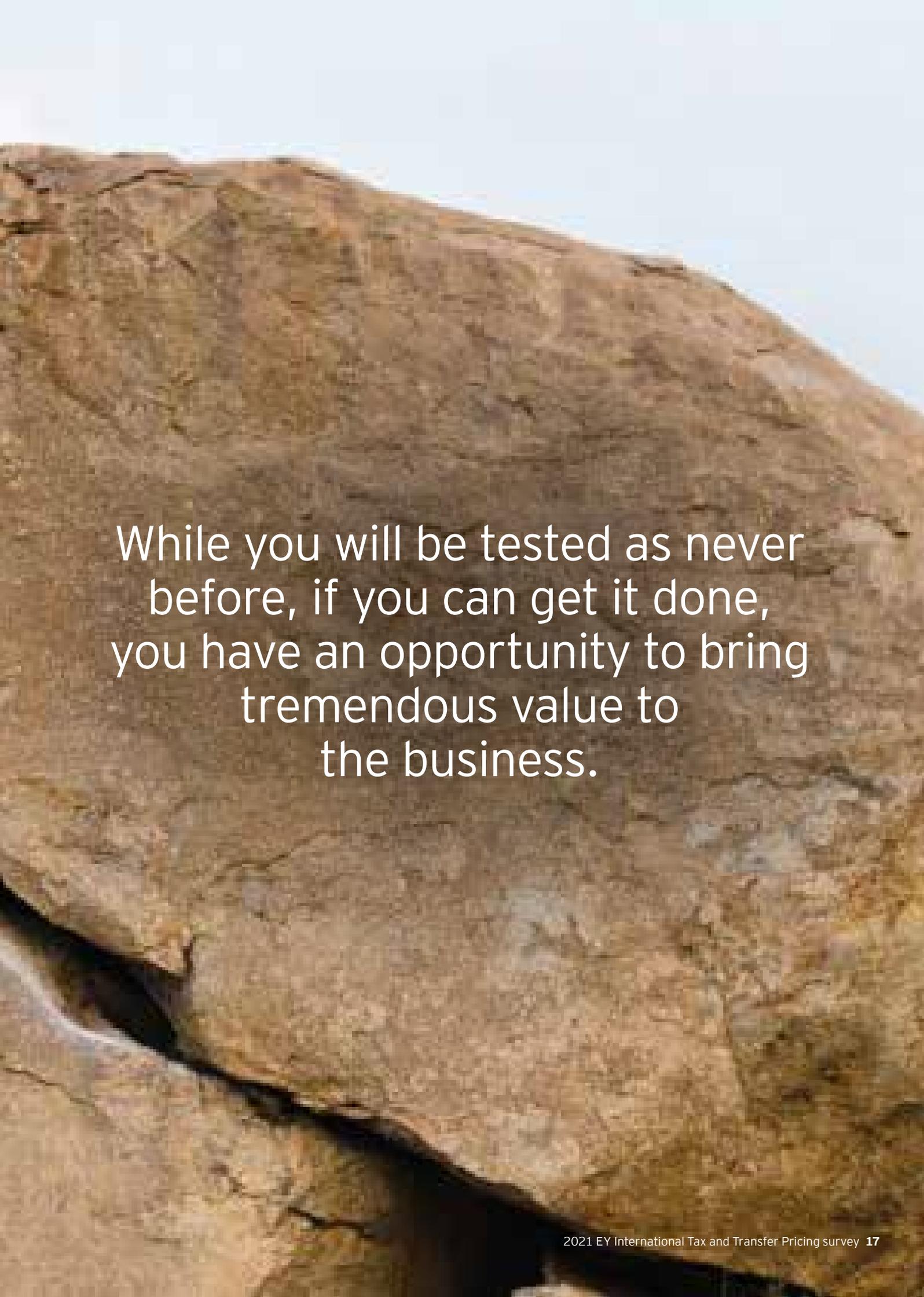
Where from here?

For TP executives at large, things are about to become more challenging. As Fultz concludes, “you must streamline and automate to make the most of limited resources. You must adjust your focus to the needs of the business and become proactive in terms of controversy. You will be under nearly constant pressure, which means you must also be agile and flexible.”

But in the end, Fultz says, “while you will be tested as never before, if you can get

it done, you have an opportunity to bring tremendous value to the business. To prepare, TP executives need to take stock of their resources and focus. Not only will their teams need greater alignment with their businesses, the TP function itself will need to streamline its processes plus embrace digital models if it hopes to achieve the needed efficiency, agility and resiliency.”





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