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Strategic Control of Transfer Pricing in a BEPS Context

This article provides an overview of key concepts for controlling transfer pricing strategies based on the Levers of Control framework.

1. Introduction

In the context of the BEPS Final Reports released by the OECD on 5 October 2015, the need to develop and implement strategies for international transfer pricing has been further intensified. Currently, the quality of transfer pricing strategies across multinational enterprises (multinationals) varies significantly. Some multinationals have fairly advanced approaches to transfer pricing, while others still struggle with basic strategic formulation and implementation – or seem to have no formal strategic approach at all.

This article provides an overview of key concepts for controlling transfer pricing strategies based on the so-called Levers of Control[1] framework.

2. Transfer Pricing Risks

The need for transfer pricing strategies in most of today's multinationals arises predominantly from the existence of transfer pricing risks in the tax domain that require management. The term "risk" is usually perceived only as a phenomenon of potential downside variation in some accounting-based variable that approximates economic reality, for example costs or net margin. Generally, risk is a measure of potential variance from an expected outcome and thus, theoretically, it is not by definition a measure of only potential *negativity* in a future economic result or outcome. This implies that risks, including transfer pricing risks and their potential spillover effect on other key economic items, can entail potentially *positive* deviation from expectations, as well. An example of this is the risk of an upward transfer pricing adjustment in a low-tax jurisdiction with a full corresponding adjustment in a high-tax jurisdiction.

However, in most cases in practice, existing transfer pricing risks are usually perceived as negative and larger than desired, turning the majority of transfer pricing activities within multinationals into an exercise of reducing the likelihood of negative events. Such a line of thinking seems even further apparent following the release of the BEPS final reports that have implications for transfer pricing. Thus, this will also be the implicit assumption in this article.

Specifically, there are a number of contextual factors inside and outside of a multinational that contribute to the emergence and ongoing existence of transfer pricing tax risks. Some of these factors are specific to certain industries or multinational structures. However, at a more categorical level, most types of transfer pricing risks appear to be common across different types of value chains, tax jurisdictions, etc. These more fundamental risk categories, which by nature may overlap, are:

– *regulatory risks*, which stem from a lack of transparency in regulations and their application by tax authorities, tax authority aggressiveness or changes in current rules. These risks are expected to increase following the OECD BEPS initiative, as there is some uncertainty as to how the BEPS deliverables will be implemented in local legislation and how tax authorities will apply these deliverables;[2]
– *technical risks*, which relate to the limited quality of a multinational's transfer pricing positions, such as a lack of coherence between structural attributes (for example functions, assets and risks of individual entities) and remuneration. The BEPS final reports regarding particularly Actions 8-10 has increased this specific risk for multinationals;
– *system risks*, which emerge from limited reliability/functionality in information systems (e.g. ERP systems and relational databases) and internal controls that interact with transfer pricing. This relates not only to material transfer pricing, as the country-by-country reporting requirements (the BEPS Action 13 Final Report) also increase the importance of having information systems that enable an efficient analysis and extraction of data; and

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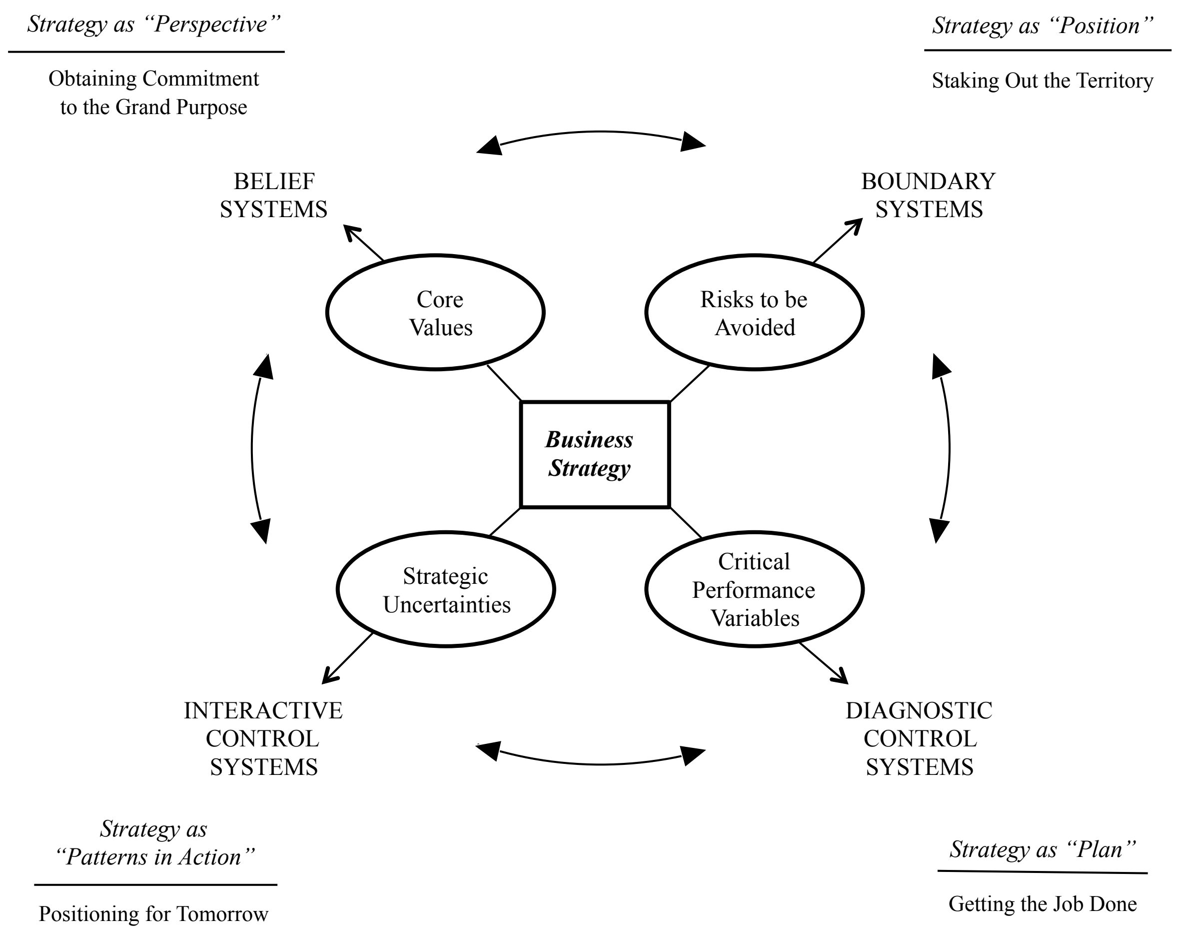
1. R. Simons, *Levers of Control: How Managers Use Innovative Control Systems to Drive Strategic Renewal* (Harvard Business School Press 1995).

2. For example, based on an analysis of the development, enhancement, maintenance, protection and exploitation functions (DEMPE functions), the tax authorities may take the stand that a contract R&D entity previously remunerated on a cost-plus basis, in light of the BEPS Actions 8-10 Final Reports is now entitled to a non-routine profit and claim that the entity was not engaged in contract R&D to begin with. As a result, the tax authorities can claim non-routine profits retrospectively.

Figure 1: The Levers of Control framework[3]



– *silent risks*, which are risks that are unknown by the multinational's tax function (e.g. undetected inter-company transactions).

3. Controlling Transfer Pricing Strategies

The transfer pricing risks in an environment both before and after the OECD BEPS initiative require that multinationals develop some form of structured approach or plan, i.e. a "strategy", to increase the likelihood that both pre-defined and emerging strategic objectives can be met. In general terms, strategy refers to the way an organization adapts to internal and external factors in order to achieve objectives. As indicated above, in most cases – including international transfer pricing – this adaptation usually takes place under uncertain circumstances, meaning that some degree of unpredictability, and thus risk, exists.

The key for multinationals is to identify and reduce uncertainties related to those external and internal factors that can cause – or at least indirectly contribute to – potential variance (i.e. risk) from planned transfer pricing outcomes and ultimately the organizational objectives. This holds regardless of whether a multinational's formal transfer pricing objective is directly related to quality in transfer pricing (e.g. application of arm's length prices) or relates, for example, to the effects on financial accounting of certain transfer pricing practices (e.g. effective tax rate predictability).

As a working definition, the authors define a transfer pricing strategy as the actions by which a multinational seeks to identify and adapt to factors that may impact the achievement of transfer pricing objectives. Successful control of transfer pricing strategies is an exercise of balance. Specifically, a multinational needs strategic controls that balance (i) in-house values and tight monitoring of pre-set critical performance variables for transfer pricing with (ii) innovation and interaction in relation to the multinational's current and future transfer pricing model.

Such types of strategic control are at the heart of the Levers of Control framework. In the following sections, this framework is introduced. The authors explain its conceptual idea and elements, i.e. the individual controls. In addition, the framework is placed in a transfer pricing context and its application is illustrated.

3.1. The Levers of Control framework

The Levers of Control framework (Figure 1) provides four distinct types of controls to manage organizational activities linked to strategic objectives:

– *belief systems* are formal systems that managers can use to define and communicate the organization's core values to key employees;

3. Adapted from Simons, *supra* n. 1, at 159.

– *boundary systems* are formal systems that managers can use to establish and communicate explicit limits on opportunity-seeking behaviour;
– *diagnostic control systems* are formal systems which assist managers in monitoring and rewarding the achievement of specific quantitative and qualitative goals; and
– *interactive control systems* are formal systems used by managers to stimulate organizational learning and the emergence of new ideas and strategies.

The framework's inherent assumption is that strategies are not a static phenomenon but require ongoing assessment and refinement to reach an equilibrium between a company's strategy and its contextual circumstances. Specifically, the framework assumes that strategic control requires some types of control systems that enhance organizational inspiration and learning based on organizational values, and others that constraints the scopes of accepted organizational practices as well as closely monitor and reward the achievement of explicit objectives.

Moreover, the Levers of Control framework is *information*-oriented in the sense that the four controls serve the purpose of either conveying or collecting information between top managers and lower organizational levels: belief systems and boundary systems are the top-down information conveyers, whereas diagnostic and interactive controls provide for bottom-up information transfers.

The discussion here will outline the way these types of controls can be used by top managers responsible for corporate tax to control transfer pricing strategies and achieve the inherent objectives. As different managerial structures apply to individual multinationals, when the authors use the term "corporate tax manager", they are referring to those in-house top managers that are ultimately responsible for a multinational's tax and transfer pricing policies and operational practices. This may be the CFO or a corporate tax director, or a position of joint responsibility shared among these individual high-level managers.

On the other hand, the authors consider corporate transfer pricing managers, as well as tax and finance staff members at lower organizational levels, to be the operational staff that deal with day-to-day operations and thus the actual implementation of transfer pricing strategies. Notably, this is the case regardless of whether these staff members are located centrally (e.g. at a centralized tax department responsible for implementing the multinational group's transfer pricing model) or locally (e.g. finance managers or transfer pricing managers at foreign subsidiaries).

3.1.1. Belief systems

Belief systems are formal systems that corporate tax managers can use to define and communicate the organization's core values to key employees. The overall idea of these types of system is to guide opportunity-seeking behaviour of individuals directly involved in the application of the organizational tax values and beliefs, and make sure that they understand the organizational purposes related to this. These systems typically take the form of formal documents – physical or online-based – such as mission and vision statements, credos and statements of purpose.

In the context of transfer pricing, belief systems should be established by the C-suite and subsequently reformulated into an actual transfer pricing policy by the corporate tax department.

Specifically, belief systems can take the form of both external and internal statements, such as official policies expressing the multinational's official position, as well as in-house formal guidelines regarding the multinational's overall tax strategy and the values (beliefs) upon which it is founded. Notably, this type of control system should be kept rather high-level and should *not* be seen as detailed, narrow descriptions of the *limits* (e.g. specific quantitative earnings targets) within which the tax and transfer pricing staff of a multinational can seek to establish value-based tax and transfer pricing practices.[4] Instead, belief systems should serve as more positive, open-ended guides for communicating how the multinational perceives itself in the tax domain and how it seeks to provide value and quality outputs for its "customers", typically tax authorities and ultimately the society in which it operates, through a certain approach to transfer pricing.

Ultimately, belief systems should serve to reduce organizational uncertainty with regard to the mission, vision and fundamental values and beliefs upon which transfer pricing behaviour should be based. Thereby, these systems can provide guidance for the staff of a multinational in their understanding of how that multinational seeks to respond to various opportunities and challenges that emerge in relation to transfer pricing.

Examples from practice include the official tax position (excerpt) of Novozymes, a large European-based multinational in the biotech industry, stating as follows:[5]

> Novozymes Position: Tax
>
> We continuously work to fulfill our tax obligations in the countries where we operate. We seek to obtain a competitive tax level in a fair and responsible way, and with full regard to national and international laws and regulations.
> We appreciate the need for maintaining a stakeholder dialogue on tax matters. To meet our objectives:
> – We follow national and international tax laws as well as the OECD guidelines on transfer pricing
> – We work with tax risk management to handle financial and reputational risk
> – We work to obtain a competitive tax level given the scope of our commercial operations and governmental tax incentives
> – We seek good relationship with tax authorities to ensure compliance and to minimize risk of disagreements and double taxation
> – We proactively engage in bilateral tax agreements to increase predictability
> – We seek dialogue and openly and honestly communicate on tax with the aim of giving our stakeholders relevant insight to understand our financial results. As for other business information, communication needs to be balanced with respect to confidentiality.

4. Instead, these limits and consequences of violating them are communicated through the boundary systems. *See* section 3.1.2.
5. *Novozymes Position: Tax*, available at http://www.novozymes.com/en/about-us/positions-and-policies/Novozymes-positions/Pages/Novozymes-position-Tax.aspx (accessed 5 Oct. 2015).

> It is important for Novozymes to make a positive contribution in the countries where we operate. Besides taxes, our economic contributions consist of duties, VAT, employee taxes, employee pension and benefit programs, procurement from local vendors and development of workforce, among others.

The position of Novozymes on tax gives an overall understanding of company values, stressing key concepts for organizational tax behaviour, such as dialogue, openness, honesty, proactivity, compliance, fairness, responsibility, etc., to achieve a competitive tax level in compliance with applicable laws.

Similar conservative and compliance-oriented values can be found in an excerpt of the Walt Disney Company's Standards of Business Conduct,[6] which states as follows:

> We are committed to full compliance with the law, wherever we operate. If you are responsible for acting on our Company's behalf in providing financial information, complying with the tax laws or meeting cash-related reporting requirements or any other legal or regulatory requirements, always be accurately and timely. Moreover, never destroy, discard, tamper with, conceal or make any false entries on documents you provide to government agencies or officials.[7]

When both internal and external documents on a multinational's core tax and transfer pricing values exist, it is critical to make sure that such documents are closely aligned. Thus, having an external tax policy that talks about "conservative tax and transfer pricing policies" and an in-house vision of "top-three lowest effective tax rate in the industry" will probably cause in-house confusion and misunderstandings. The authors note that this is a general recommendation of ensuring alignment between externally and internally communicated values and priorities, and hence should not in any way be linked to those multinationals mentioned in this article.

3.1.2. Boundary systems

Boundary systems are formal systems that corporate tax managers can use to communicate the scope within which opportunity-seeking behaviour with regard to transfer pricing is allowed. The purpose of these systems is to avoid risks that emerge from the use of belief systems, i.e. communication of core values. Specifically, whereas belief systems provide positive energy and motivate the search for new opportunities and innovative approaches to transfer pricing, boundary systems constrain the search to specific *domains*.

With regard to this, it is tempting for corporate tax managers to assume that implementation of belief systems will lead to an organizational understanding of accepted behaviour, and that transfer pricing tax risks caused by improper behaviour by the corporate tax department (as well as transfer pricing staff at foreign subsidiaries) are thereby generally avoided. However, this is certainly not the case and, as demonstrated below, boundary systems play the critical role of constraining those opportunity-seeking activities instigated by belief systems.

As the transfer pricing exercise is unique from a strategic control perspective due to its core foundation's usually being to manage tax risks, naturally the belief systems will at least implicitly define some of the key risks that top management seeks to avoid – but often do not succeed in avoiding – in sufficiently constraining and explicitly negative terms. The purpose of the boundary systems in the context of transfer pricing is to specify in detail the risks that the top management seeks to avoid, including some of those risks that are intrinsic to certain practices which, at a more general level, are in line with core values, but which may still be unacceptable from a top management perspective.

One example is the disallowance of a transfer pricing model that is technically considered to be in full compliance with existing regulations and is yet aggressively structured to minimize the effective tax rate at the group level. Here, in addition to the core risk of whether tax authorities actually consider it to be at arm's length, there is a risk of public criticism and its negative impact on a multinational's image; indeed most multinationals will seek to avoid both risks. Another example could be the disallowance of structuring local subsidiaries in high- and low-tax jurisdictions differently (e.g. as toll manufacturers vs. fully fledged manufacturers) to utilize tax rate differentials and work around strict profit repatriation rules, even though the functional profile and remuneration can be substantiated from an arm's length perspective. Finally, disallowance of IP ownership in tax havens or low-tax jurisdictions as part of an intercompany pricing model, regardless of whether the intercompany remuneration is considered to be at arm's length and generally accepted by tax authorities, illustrates a formal boundary.

Boundary systems serve the purpose of communicating to transfer pricing managers and staff the specific domain of accepted behaviour and limits of opportunity-seeking, and – unlike belief systems – they do not specify positive standards and ideals. Thus, in contrast to belief systems, which are used to communicate the multinational's core values on transfer pricing, etc. in a positive spirit, boundary systems provide specific and explicit boundaries for operational staff through the use by top management of prescriptive, negatively-laden formal statements and the multinational's formal transfer pricing policy.

An example can be found in an excerpt from the Tax Risk Management Strategy of Vodafone,[8] which explicitly limits accepted behaviour in the tax domain to the requirement of a commercial purpose:

> The [Vodafone] tax code of conduct provides that we will enter into tax planning where the financial benefit is tax related but we will *not engage in artificial tax arrangements.* The test of artificiality is generally aligned with the existence of commercial purpose.

6. Walt Disney Company & Affiliated Companies, *Standards of Business Conduct* (2012), available at http://cdn.media.ir.thewaltdisneycompany.com/forms/DIS-SBC-CM.pdf (accessed 5 Oct. 2015).
7. Id., at 33 (excerpt).
8. Vodafone, *Tax Risk Management Strategy*, available at https://www.vodafone.com/content/dam/sustainability/pdfs/vodafone_tax_risk_management_strategy.pdf (accessed 5 Oct. 2015)

> Some such cases could include, for example, the rationale for and ability to hold investments in other entities of the group, or the choice of tax jurisdiction for the undertaking of certain activities or the involvement of a particular entity in a transaction, or the role of a particular entity in a transaction.
>
> The use of such arrangements would be "artificial" where there is otherwise *no commercial purpose for the activities* or if the attribution of profits or other benefits to a jurisdiction were not based on the actual activities and capabilities but merely on a contractual description of rights for which no capability exists.
>
> Other artificial arrangements could include the provision of debt where there is *no commercial rationale*, provision of goods and services where there is no benefit to the recipient, the routing of transactions either financially (for withholding tax) or physically (for VAT) through companies which play no part in the underlying commercial arrangements.[9]

In practice, the lack of or insufficient boundary systems specifically targeting transfer pricing is often one of the main weaknesses in the transfer pricing strategies of multinationals. Specifically, the level of boundary specification for the material transfer pricing approach of the multinational is often too low and/or stated in overly aggregated terms for operational staff to clearly understand the scope within which opportunity-seeking behaviours are acceptable to top management. It is therefore stressed that the tools for strategic control of transfer pricing should comprise "negative" controls that explicitly and thoroughly communicate appropriate boundaries, including specific examples (e.g. Vodafone, *see* above) for in-house transfer pricing staff to determine and truly understand what behaviours are considered inside or outside these formal boundaries.

In addition, such boundaries should not be static; rather they should be frequently updated to reflect the current situation of a multinational's tax regulatory environment and its transfer pricing history (e.g. results of tax audits), as well as the appetite of the current top management for tax risks. As all three (and many more) factors change on a regular basis, so should the formal boundaries of accepted behaviour. In reality, this is not always the case.

Generally, a multinational's core values as applied to transfer pricing require operational guidance and, notably, limitations for corporate tax, as well as transfer pricing managers and staff. However, as some multinationals use external consultants for many transfer pricing exercises, it is also critical to ensure that the entire transfer pricing function – including external consultants – are aware of and align their ideas and inputs with the multinational's formal boundaries.

As part of this, it is critical that the multinational responsible of transfer pricing not be intimidated by or uncritical towards external consultants' various transfer pricing suggestions or innovations that potentially are not aligned with top management objectives and priorities. In this regard, some transfer pricing managers have found themselves in trouble by not filtering inputs from external consultants in accordance with existing beliefs and boundaries. This is by no means a criticism of external consultants; rather it emphasizes how important it is that external consultants and in-house transfer pricing staff align their inputs and actions to the formal beliefs and boundaries of the top management of the multinational.

3.1.3. Diagnostic control systems

Whereas belief and boundary systems belong to the category of control systems that guide the domain of appropriate organizational transfer pricing activities, diagnostic control systems are more classical feedback control systems, meaning that they are used to govern (correct) unwanted variance in organizational activities and results. Specifically, diagnostic control systems provide variance information to corporate tax managers to enable their ex post monitoring of organizational outcomes and the potential need for correcting deviations from pre-set performance targets and standards.

In the context of transfer pricing, probably the most basic type of diagnostic control system is an ongoing, bottom-up collection of quantitative information regarding subsidiary earnings through some sort of ERP application or, in some cases, customized tax/transfer pricing software solutions. These systems provide a basis for risk and variance analyses, where, for example, actual subsidiary EBIT margins are measured against some pre-set standard of accepted (i.e. arm's length) performance.

For some multinationals, a broader scope in their diagnostic controls for transfer pricing (e.g. due to detailed reporting requirements and expectations from capital markets) may be relevant. This could include the integration of other tax measures with which transfer pricing results interacts, such as effective tax rates or cash taxes. Also, diagnostic controls to provide early warnings when product volumes and/or mixes deviate from expectations and ultimately impact on critical transfer pricing and tax reporting items, are relevant for multinationals.

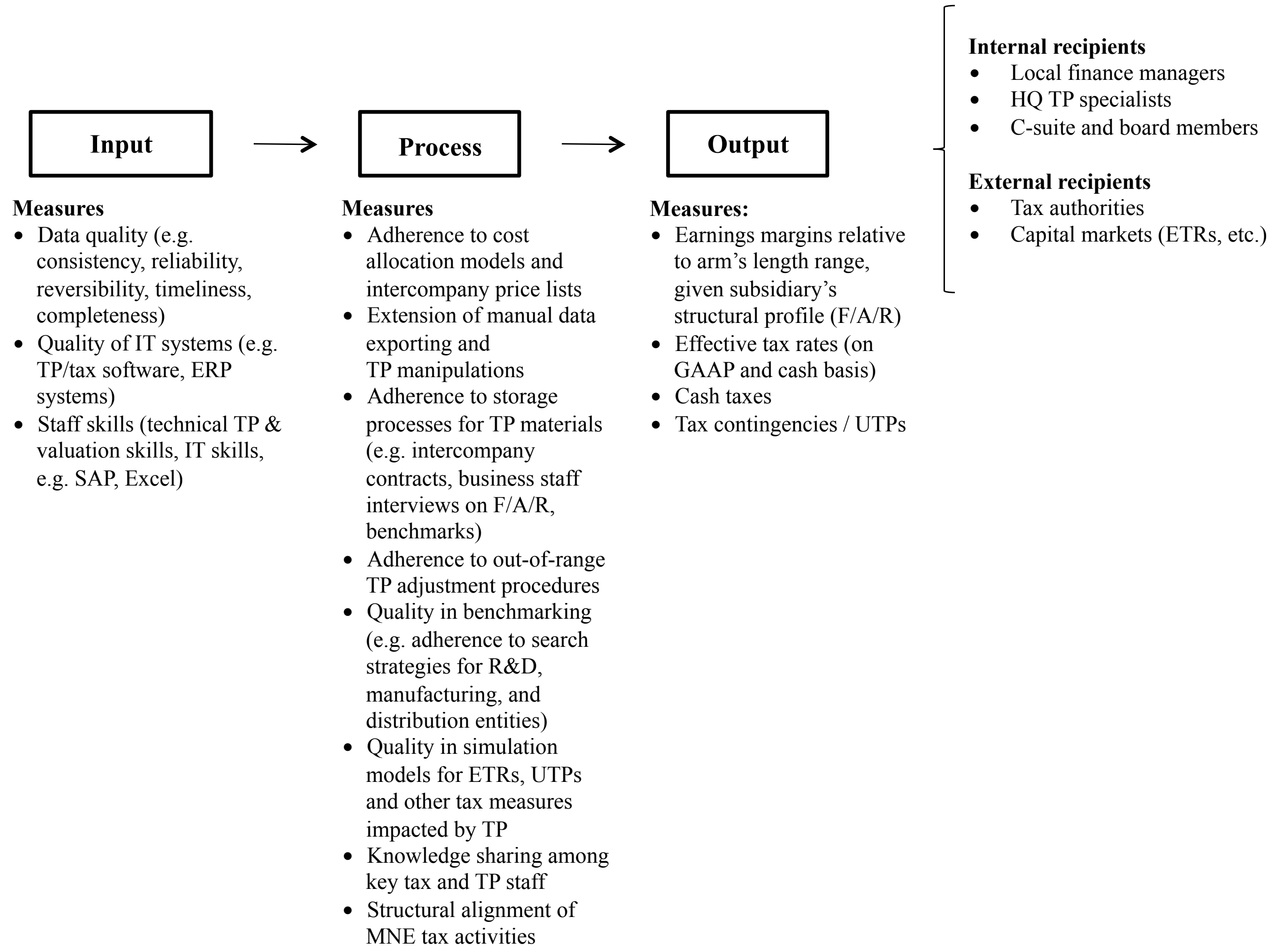
3.1.3.1. Output measures versus input/process measures

While diagnostic controls measure and monitor outputs, the achievement of most organizational activities, including transfer pricing, relies to a large extent on quality in *inputs* (e.g. accounting data, staff, information technology) and the application of minimum standards for various *processes*. One of the main weaknesses in today's diagnostic controls for transfer pricing in multinationals – intensified by the requirements in several Final Reports – is that the applied critical performance variables are often strictly measures of *outputs*.

Specifically, in many of the multinationals observed in practice, the diagnostic controls for transfer pricing consist strictly in measuring variance from some pre-set range of acceptable earnings margins (i.e. output) given a certain functional profile of a specific subsidiary, and then assessing once every quarter (or, worse, once a year) if actual earnings are within range. When they are out of range, an adjustment is made to the prices of certain products that have a larger impact on earnings, thereby bringing the subsidiary's earnings within range.

9. Id. (emphasis added).

Figure 2: Transfer pricing performance measures



The problem with this approach is that solely measuring variance on outputs and fixing it through a high-volume product adjustment does not explicitly take into account the importance of quality in the preceding inputs and their processing. Nor does it provide a good basis for organizational learning, i.e. identifying the cause of a potential deviation and how to avoid it ex ante.

Instead, if measuring more explicitly on the preceding inputs and processes from which transfer pricing outputs are derived, multinationals would force themselves to determine more explicit criteria for what constitutes quality inputs and subsequent processing. In addition, this exercise would help them obtain a more in-depth understanding of why potential earnings deviations occur. Finally, it would send a message throughout the organization that the use of quality inputs and strict adherence to transfer pricing processes are a (monitored) priority of the multinational.

In many cases, lack of, or weakness in, input quality and adherence to critical transfer pricing processes is not discovered or understood before the development of documentation material takes place or, worse, during transfer pricing audits.[10]

Examples of specific *input* measures are *data consistency*, such as measures to ensure that transfer pricing staff extracts data on similar cost types to determine, for example, the cost of goods sold across a pool of group contract manufacturers, or *data reliability* such as measures to test for errors in data entries to specific ERP modules and accounts. Another example is measuring *adherence to intercompany product price list*, for example by the use of sampling, to avoid out-of-range results caused by incorrect internal price applications. Similarly, measures of *human* inputs to the management of transfer pricing include *staff skills*, in order to evaluate their transfer pricing technical skills (e.g. pricing, valuation), as well as skills related to, e.g. ERP, Excel, and tax/transfer pricing software applications. Unfortunately, these types of measures are often overlooked or downplayed by some multinationals, although their substance ultimately has a significant impact on a multinational's transfer pricing risk exposure.

One example of a process measure is *adherence to cost allocations for management fees* according to formal process descriptions for the determination of shareholder costs (non-allocable), correct application of method and allocation bases. Other critical process measures include the

10. The overemphasis on output-focused performance measures is not confined to transfer pricing, but applies more generally to activities performed by the tax function of a multinational. *See* e.g. the *Corporate Tax Department Survey 2011-2012* (Tax Executives Institute 2012), at 23.

extent of manual data exporting and transfer pricing manipulations, to assess the extent to which transfer pricing and related tax reporting/financial accounting items are exposed to various system risks, including the potential inability to reconstruct the intercompany transaction trial. Unfortunately, many multinationals are still struggling with an excessive degree of manual, old-fashioned transfer pricing procedures, partially due to the lack of implementation of information technology applications that could support the automation of intercompany trade.[11]

Generally, multinationals reassessing their diagnostic controls in a BEPS environment should avoid strictly using quantitative/easy-to-measure performance variables. If the tax function of a multinational is to be successful in transfer pricing, the application of more qualitative/hard-to-measure performance variables is also necessary, even though these entail high degrees of subjectivity. For example as transfer pricing interacts with many aspects of direct and indirect taxes (e.g. withholding taxes and customs), internal knowledge sharing is crucial to avoid the use of transfer pricing solutions that conflict with other aspects of a multinational's corporate tax and in-house tax planning. Therefore, internal measures or at least some form of formalized assessment of issues (e.g. knowledge sharing among key tax and transfer pricing staff; structural alignment of tax activities of the multinational) should be an explicit priority in corporate tax managers' measurement of performance related to transfer pricing.[12]

In summary, the general point is also to include diagnostic controls – whether quantitative or qualitative – that deal explicitly with those inputs and processes that cause the final results, rather than a narrow (quantitative) measurement of outputs alone. Figure 2 provides examples of performance measures for transfer pricing inputs, processes and outputs.

3.1.3.2. Performance rewards and penalties

To be effective and to signal to transfer pricing managers and staff that selected performance measures are a strategic priority, critical performance measures should be tied to the reward system of the multinational. Specifically, achievement of pre-set transfer pricing goals with regard to specific measures (input, process and output measures) should be rewarded, and the lack of achievement should carry some form of negative consequence.

In this regard, it is critical to bear in mind that while the monetary reward is obviously appreciated to some extent by key transfer pricing staff members, organizational recognition can also play a significant role in the motivation of the transfer pricing staff to succeed. Some corporate tax managers seem to underestimate the importance of communicating to transfer pricing staff their appreciation and recognition of a job well done, including the effect of doing this in a public setting, such as at formal in-house group meetings, or recognition in company publications or during formal individual annual assessment interviews.

Finally, a common weakness in the reward systems of multinationals is that measures for transfer pricing staff are often not timely. For example rewarding transfer pricing managers and staff based on measures such as "lack of transfer pricing surprises" lacks reasoning, as most of these surprises (e.g. significant audit adjustments, materialization of potential double taxation risks) go back many years, often to a time when other individuals were responsible for the decisions causing the actual risk.

The same argument (but with the reverse timing criticism) goes for rewards tied to other more general tax items, such as low effective tax rate or cash taxes. In this case, current transfer pricing decisions (e.g. on a highly aggressive transfer pricing model) can lead to current tax results that might be greatly appreciated and rewarded by top management (e.g. low effective tax rate), but which may later (e.g. following a transfer pricing audit) prove to be costly and unwanted, such as restatements to financial reporting when effective tax rates for previous years are found to be understated due to non-arm's length transfer pricing.

3.1.4. Interactive control systems

Interactive control systems are intended to serve as a catalyst for organizational experimentation and learning about strategic uncertainties. Specifically, whereas diagnostic control systems are designed to assist top management in assessing whether the current transfer pricing strategy is on track, interactive controls force organizational members – including transfer pricing specialists – to continuously evaluate emerging threats and opportunities, as well as whether the assumptions upon which the current strategy rests, remain valid. The organizational pressure to look for potential changes in contextual circumstances that will potentially require an organizational response is fundamentally created by top managers (CFOs/corporate tax managers) involving themselves in (i.e. interacting with) the decisions made, and contextual perceptions held by, operational transfer pricing staff.

Corporate tax managers cannot rely only on well-established diagnostic controls for managing transfer pricing strategies. In light of the BEPS Final Reports, they need systems that stimulate an organizational search for threats and opportunities linked to the transfer pricing model of the multinational. If such systems are not in place, a multinational risks that the course set in diagnostic controls (which is based on previous perceptions of the transfer pricing environment) is flawed or downright wrong without proper actions taken to correct it. Interactive controls ensure that top management gets involved with the multinational's operational transfer pricing specialists and their specific transfer pricing decisions to cope with the uncertainties that emerge from the OECD BEPS initiative. More specifically, the interaction stimulates the organiza-

11. Ernst & Young, *2013 Global Transfer Pricing Survey* (EYGM Ltd. 2013), at 21, reports that 41% of the respondents' (accounting/monitoring) systems are not set up for tax and transfer pricing, 58% rely on Microsoft Excel spreadsheets to perform transfer pricing analytics, and only 7% report having "highly automated systems supporting transfer pricing data needs for analysis, monitoring and planning".
12. For further inputs to the management of transfer pricing knowledge, *see* e.g. C. Plesner Rossing & T.C. Pearson, *Transfer Pricing Knowledge Management Systems*, 21 Intl. Transfer Pricing J. 4 (2014), Journals IBFD.

tional understanding and awareness of strategic uncertainties, i.e. the contingent factors – whether identified or not – that could threaten the current transfer pricing approach of the multinational.[13]

Notably, strategic uncertainties of transfer pricing can relate to both internal and external circumstances. Examples of internal uncertainties relate to whether future business-strategic decisions by multinationals will alter current business models and make existing transfer pricing approaches invalid. Generally, internal uncertainties are typically intensified in multinationals where the tax function is poorly integrated with strategic business functions and related decisions.

On the external side, uncertainties can relate to whether tax authorities could be moving towards a preference for different benchmarking practices in light of the BEPS Final Report on Actions 8-10. Moreover, uncertainties have emerged with regard to how current structures involving permanent establishments (BEPS Action 7 Final Report) should be treated in the future, and whether Action 7 potentially jeopardizes the existing transfer pricing practices of some multinationals. These Actions also entail uncertainties with regard to the fundamental interpretation of key concepts for transfer pricing (e.g. intangibles and risk), including how to combine the objective for tax-efficient supply chains with an acceptable level of transfer pricing tax risk in the context of the OECD BEPS initiative.

Interactive controls should also be activated following any transfer pricing audit adjustments, whether BEPS-related or not. Specifically, corporate tax managers should enquire ex post about what has been done wrong – which assumptions have failed and, most importantly, how the multinational can adapt in future, including which subsidiaries not included in the audit are perceived to be exposed to similar issues. In this way, interactive controls have the built-in feature that they implicitly force operational transfer pricing managers and staff to consider potential problems and prepare answers to corporate tax managers when significant transfer pricing risks materialize or have the potential to do so.

The above examples illustrate transfer pricing uncertainties and related questions that corporate tax managers within multinationals should discuss on an ongoing basis with their operational transfer pricing staff in order to stimulate the organizational search for critical information inside and outside of the multinational. The goal is to ensure an ongoing alignment between organizational practices and contextual circumstances. Interactive controls can help facilitate these types of communicative activities throughout the organization and at different organizational levels. Specifically, they can stimulate centralized dialogue and learning through formal meetings between, for example, a corporate tax manager and her transfer pricing manager or between a transfer pricing manager and full-time specialized transfer pricing staff at headquarters; or more decentralized interaction such as that between a subsidiary's finance manager and its tax controllers.

To be sure, these formal debates and dialogues constitute actual interactive control. The experimentation and learning of uncertainties throughout the multinational, such as the response of tax authorities to aggressive applications of a lower-than-average earnings margin in specific subsidiaries of the multinational, or use by the multinational of non-conventional cost allocation practices, are not actual interactive controls. Instead, they exemplify the fuel (i.e. input) for strategic debates at interactive meetings. By bringing this type of knowledge to interactive meetings, operational transfer pricing staff and corporate tax managers can jointly assess whether the current perception and assumptions upon which current transfer pricing strategies are based remain valid, or whether adjustments are required. Thus, interactive controls stimulate and form the emergence of new strategies. They ensure that outdated strategies and practices, not aligned with existing contingencies for transfer pricing strategic success, are adjusted in order to keep the multinational on the right track towards the achievement of its transfer pricing objectives.

3.1.5. Sources of information

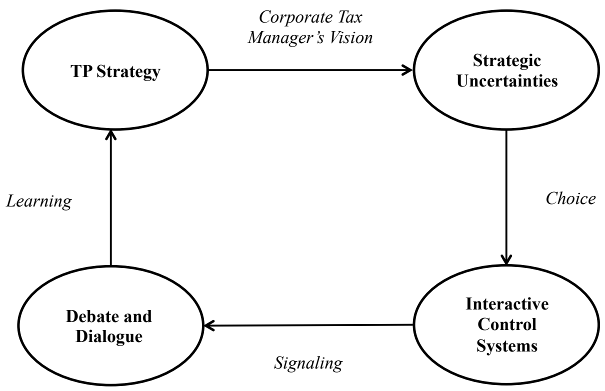
Interactive control has no pre-established format, but can take place, for example, through face-to-face or online meetings between top managers (CFOs, corporate tax managers) and their transfer pricing staff. The underlying sources of information that transfer pricing staff can use to gather information for the debate and dialogues at interactive meetings should be highly varied and draw upon both headquarters and subsidiary staff knowledge, in order to ensure that different types of opinions and perceptions of the transfer pricing environment of the multinational are introduced. However, it is also critical to include staff that are involved in other areas relevant for the quality of transfer pricing strategies. This includes, for example, indirect taxes, accounting, tax accounting, legal, internal auditing, information technology, which influence or interact with transfer pricing, and where various dynamics (such as regulatory changes or introduction by multinationals of new ERP applications) impact the quality of current transfer pricing models.

Notably, informational sources should go beyond formal organizational boundaries. Specifically, tax and transfer pricing specialists at all organizational levels of multinationals should take part in formal as well as informal inter-organizational networks of multinational tax and transfer pricing specialists to enhance the likelihood that the threats and opportunities in their transfer pricing environment are picked up and brought back to interactive control meetings. Such networks are critical to ensure that current, sometimes highly sensitive, issues of transformation in transfer pricing environments and their implications for the multinational's individual transfer pricing model can be confidentially discussed.

These networks are also significant ways for individual multinationals to benchmark their own transfer pricing

13. Strategic uncertainties are defined as "the uncertainties and contingencies that could threaten or invalidate the current strategy of the business" (Simons, *supra* n. 1, at 94).

Figure 3: Emergence of new transfer pricing strategies by use of interactive control systems



models and structural issues against multinationals in similar jurisdictions, industries, etc. In order to make such inter-organizational networks effective, as well as stable over time, it is essential not to be overly secretive about one's own transfer pricing practices and merely absorb the learning from one's peers. Instead, a give-and-take attitude should be applied. Finally, external advisors can assist with opinions on potential threats and opportunities in the transfer pricing environment and may thus serve as informational inputs to interactive control meetings, as well.

The underlying logic of interactive control systems can be illustrated as a dynamic wheel of strategic refinement. For any selected transfer pricing strategy, a pool of strategic uncertainties – now even more intensified by the release of the BEPS Final Reports – exist inside and outside of the multinational that are not fully understood or known by corporate tax managers and transfer pricing staff. In response, interactive control systems can be used to signal to transfer pricing staff the need for organizational enquiry about these uncertainties. Corporate tax managers, transfer pricing managers and staff should have downward organizational debates, as well as participate in inter-organizational networks of learning with fellow multinational specialists about transfer pricing uncertainties. The repetitive debate and dialogue can inspire new learning and ultimately create the necessary strategic refinement to ensure that the transfer pricing model of the multinational is aligned with the regulatory environment following the OECD BEPS initiative on an ongoing basis. Figure 3 illustrates this reasoning.[14]

4. Conclusion

As new regulations are expected to be introduced as a result of the OECD BEPS initiative, transfer pricing strategies remain pivotal for multinationals and should not be considered merely as a window-dressing phenomenon.

By introducing different types of managerial controls, multinationals can enhance the quality in the implementation and ongoing assessment of current transfer pricing strategies in place. Specifically, the four systems (levers) help multinationals both convey and collect critical information from inside and outside of the organization in order to ensure that current transfer pricing strategies are on track, with both internal firm developments and developments in the external environment – especially regulatory developments arising as a result of the OECD BEPS initiative. Moreover, they can assist ensuring that all transfer pricing uncertainties are addressed on a regular basis, which in turn will result in potentially refined and even new transfer pricing strategies.

14. Figure 3 is based on Simons, *supra* n. 1, Figure 5.3, at 102.