

## INTERNAL AUDIT AND TRANSFER PRICING: EVOLUTIONARY INSIGHTS

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### **Abstract:**

*Corporate groups, as a prevalent global organizational solution for economic transactions, offer risk mitigation but raise fiscal challenges. This study investigates corporate groups, entities that transcend their individual units, and examines the strategic importance of transfer pricing policies in managing intra-group relationships. Transfer pricing, identified as the top concern for over 80% of surveyed multinational companies, plays a critical role in these organizations. It creates fiscal implications in the interactions between entities within the same corporate group. The tax strategy often operates on a global scale, prioritizing the interests of the holding company and disregarding equitable income distribution among countries. Consequently, intercompany transactions facilitate the transfer of taxable items from high-tax jurisdictions to those with lower tax burdens, impacting national and international tax revenue. This study sheds light on the intricate dynamics of corporate groups, transfer pricing strategies, and their fiscal implications in the global economic landscape, highlighting the critical importance of transfer pricing policies in managing relationships within corporate groups.*

**Keywords:** Corporate groups, transfer pricing policies, multinational companies, fiscal implications, global taxation.

### **1. Introduction**

Corporate groups are one of the most widespread organizational solutions when it comes to managing global economic transactions. If, on the one hand, they make it possible to break down and limit the business risk between a number of autonomous legal entities, on the other hand they can give rise to pathological phenomena and/or critical issues from a fiscal standpoint. The reason for examining an articulated system of enterprises, namely a corporate group, is found in a general order which, despite passing through the single units that compose it, can transcend them all (Amplius Lai, 2003).

In managing relations between entities that make up the group a strategic role is played by the transfer pricing policies. According to an authoritative survey (Ernst & Young, 2001), transfer pricing is the most important issue for over 80% of the multinational companies examined. Indeed, there is a fiscal side in the relations between the "company-country" belonging to the same corporate group, which derives from the reality of corporate groups themselves, where the tax strategy is seen on a global scale - in the interest of the holding company and, therefore, regardless of the logic of equitable distribution of income between countries - and implemented on a local basis. Therefore, intercompany transactions allow companies to shift taxable items from high-tax countries to countries with a lower tax pressure (Stevanato, 2003).

Basically, the approach, no matter how aggressive, taken by a company's fiscal strategy in managing the tax variable in intercompany transactions, to achieve the strategic objectives set by the top management, determines the level of tax risk. Indeed, the tax strategy is in turn the outcome of a more general "fiscal philosophy", including the group's attitude to aggressive and tax avoidance planning.

On closer examination, however, the issue is of an organizational and accounting nature, even before being fiscal. Until the 1980s, transfer pricing problems were part of managerial accounting: the parent company decided the best way to allocate profits among the various divisions (Levey et Wrappe, 2010). Instead, the origin is due to the continuous decentralization of the company's decisional bodies. It is generally believed that decentralization offers

numerous benefits (Flavell, 1977; Thomas, 1980). Managing transfer pricing can be a useful tool for effective cash flow management; it can respond to marketing policies or organizational needs (such as maximizing employee motivation). The transfer of responsibility from the center to the periphery can, for example, increase the performance of "peripheral" managers who, having to manage a subsidiary as if they were the sole director/entrepreneur, are forced to express themselves more effectively and more efficiently, thus achieving better results over time.

However, the potential negative aspects related to decentralisation are no less important: subsidiary managers could carry out actions that could benefit their organisation under their control to the expense of the whole company, a goal that is clearly in contrast with the central management's main objective to maximise the wellbeing of the whole group. The above physiological and open conflict is clear when we analyse, from a fiscal point of view, the relationship between the centre and the periphery in a corporate group, that is to say between the parent company and the various subsidiaries. The lack of coordination between parts of a single corporate body is the main cause of so-called "pathological" transfer pricing, which attracts the attention of the tax authorities. As is well known, intragroup relations are generally eliminated when the financial statements of the subsidiaries and their parent companies are consolidated for accounting purposes. However, the tax issue persists, since the same transactions are not subject to similar tax consolidation.

## **2. Research methodology**

From the methodological point of view, the analyses were carried out by removing the filter of national law, which is by abandoning the conceptual schemes of the Italian legal system and assuming a necessarily supranational perspective.

In the analysis of the sources, emphasis was placed on the so-called "Law in action" rather than the "law in book", thereby leveraging on the best practices of international corporate governance and on the principles recommended by the OECD: if in an internal perspective it is the relationship between the state and its citizens/taxpayers that is examined, in an external and wider perspective at the centre of the analysis is the process of interrelations between sovereign states. The bibliographic research on internal auditing has been adapted to the specific subject of the analysis (a multinational group of companies) and integrated with the empirical research gained by sector operators on the transfer pricing practices of multinational companies.

## **3. Review of literature**

The fiscal policies of every country are generally designed to meet internal economic and social needs. Globalisation has, however, led to competition between those countries that use the fiscal lever to attract foreign investments into their countries and/or hang on to local investments. One of the tools most widely used by multinational companies to exploit the differences between the different national tax systems is to manipulate transfer prices in intragroup transactions. Transfer pricing fully entered the tax debate in the 1930s when some multinationals in the United States began to use it to finalise tax avoidance practices. In 1935, the United States introduced business alignment with market values as a tool to set the prices of intercompany transactions.

Europe didn't adopt the same market parameter until 1979, when the Transfer Pricing and Multinationals Report was published, the first document published by the Organisation for Economic Cooperation and Development (OECD) on transfer pricing and which set out the criteria for determining normal value in transactions between associated companies. In tracing the beginnings of transfer pricing, we must not fail to underline the role played by international organisations, in particular the OECD, whose actions in the development of the matter have produced international initiatives that have sometimes taken on an important legislative role in shaping the matter within national laws. The publication of the above report immediately attracted the attention of those people involved in the matter in companies, and even the scientific community began to question the intragroup dynamics of large multinational groups and started to analyse the various aspects.

For example, Grabski (1985) especially highlights the organisational aspect: transfer pricing is a response to the decentralisation of organisations and the consequent business relationships developed between centres of responsibility.

Other authors have emphasised the fiscal problems: Grubert and Mutti (1991) showed, empirically, that transfer price taxation translates, ultimately, into multinationals' incomes moving to low-tax countries, as well as the gradual transfer of investments to these countries. Moreover, the mechanism used often involves the transfer of goods or services against which there are no sales figures readily available (for example intangible goods); even when it comes to goods and services other than intangible assets, the companies transfer these goods and services to countries where there are no comparable market prices, so the tax authorities are forced to use incomplete and indirect information to establish transfer prices. Bartelsman and Beetsma (2003) offered a macroeconomic perspective of the issue by highlighting how the various transfer pricing methods can influence the tax revenues of certain countries. Other research (Jacob, 1996, Conover et Nichols, 2000) focused on the propensity of companies to manipulate transfer prices. In particular, these studies have demonstrated the effect of company size on the use of transfer pricing for exclusively tax purposes and concluded that larger companies are more likely to shift income through transfer pricing.

On the other hand, the research conducted by Hyde and Choe (2005) is particular: they put forward the idea that multinationals could use "double accounting" for transfer prices: one for management purposes and one for tax purposes to determine the lowest tax for each "sub-unit". This implies, according to the authors, that a change in the group's tax policy has repercussions on the internal cost structure and, likewise, a change in the cost structure influences the transfer pricing tax policies implemented by the multinational group. Furthermore, Elitzur and Mintz (1996) also examined transfer pricing management using two sets of accounting/tax documents.

Keuschnigg and Devereux (2013), instead, questioned the ability of transfer pricing methods to reflect actual economic reality. According to the authors, the prices thus obtained (in line with the theoretical normal value) do not reflect what a third party would actually pay for the goods or services exchanged.

#### **4. The critical factors in traditional auditing in the management of transfer pricing processes**

In the modern globalised and digital economy, a considerable volume of world trade is done through intragroup transactions and involves the international transfer of both tangible and intangible assets, services and capital within the same corporate group. "Intragroup trade" between associated and non-competing players is flanked by traditional trade between companies. This means that a large number of international transactions are no longer influenced by the forces of the free market; they are influenced by "internal" forces that tend to satisfy the common interests of the entities within the group.

Given that the concept of corporate freedom also includes the "principle of freedom of establishment", it should be noted that investment planning must be carried out on the condition that the so-called "arm's length" principle developed by the OECD is respected, according to which the company must carry out intragroup transactions at the same conditions it would between independent companies. It is therefore clear that in an open and competitive market, higher income goes hand in hand with higher risk. The problem lies entirely in the *quantum*, i.e. an appropriate price must be established for the transfer of goods, services and capital within a group. One correctly observes that the allocation of group taxable income to national tax jurisdictions where the group is present is often influenced by transfer prices. The manipulation of these transfer prices is one of the most classical methods of international tax avoidance, a factor that is on the rise for unlawful purposes (Tesauro, 2013). To date, the analysis of the regulatory instruments used to combat tax evasion or tax avoidance practices used by corporate groups on an international scale has highlighted the substantial inadequacy of national tax rules in regulating a phenomenon in which "global taxpayers" are involved, given the contrast between territoriality of the norms and universality of the cases to be subjected to taxation.

From a corporate point of view, the main problems are related to audits: traditional audits cannot provide exhaustive information because they are not always suited to uncover aggressive tax planning operations and, if they can, there

is normally a wide time gap between when the planning scheme is implemented and when the scheme is discovered by the audit. Furthermore, it is not always easy to establish whether an aggressive tax planning manoeuvre uncovered by an audit can be classified as an "isolated case" or as part of a wider and worrying phenomenon.

Many of the difficulties in a traditional audit stem from the common error of not sufficiently considering the tax risk in daily business decisions but limiting oneself to "informal" tax risk management, consisting of a mere routine activity. In this perspective, the fiscal variable is seen from a strictly financial perspective, i.e. returns after tax. This traditional approach, especially by the corporate groups operating on an international scale, is no longer viable. Formal, procedural and systematic tax risk management leads to the careful management of the fiscal variable. From an operational point of view, therefore, it is necessary to include the tax area within the corporate risk management systems. In other words, one can see that the transnational relationships of corporate groups are sometimes structured in such a way as to make the related tax consequences (tax result) hardly compatible with the economic ones (business result).

This compatibility must not only be sought but must be maintained constantly. Indeed, we must bear in mind the difficulties that arise when the risks are created in different and geographically distant companies, with due regard to compliance with laws that are often very different from those binding the parent company. As well as being clearly defined and represented, transfer pricing policies must be constantly updated to comply with changes in legislation, the practices of tax authorities and the organisational, functional and structural development of the corporate group. Unlike in the past, the speed of change has greatly increased and, thus, must be addressed by developing a strong ability to manage the volatility of the internal and external environment. The logic according to which a company manages the different activities for the generation and distribution of value must be understood in a broader sense than the classical "value chain" (Porter, 1985).

The architecture of the value of modern multinationals is unstable and tends to evolve and to redefine itself continuously (Ramírez, 1999). Likewise, the organisational changes in a company often concern both the internal organisation and the ways in which the company relates to external companies. To this aim, it was noted (Christensen et Rosenbloom, 1995) that the more the company mission is characterised by elements of innovation and transnationality, the more likely the value architecture will involve a dense network of external actors. The functional evolutions that could originate from these changes must be intercepted by the group's tax managers, with due consideration to the fact that when functional reorganisation occurs, in substance, more functional discontinuity occurs than in the past, and this must be analysed and represented.

Corporate documents prepared to give an idea of the transfer pricing policies adopted (Masterfiles and Local files) often deal with corporate reorganisation but neglect to acknowledge functional reorganisation (due to the clear inability of the tax departments to identify them). The group could, therefore, unknowingly be affected by potentially unpleasant tax consequences. For this reason, the definition of transfer pricing policies presupposes a complete understanding of the structural configuration, the corporate articulation and the organisational dynamics of legally independent multinational companies, but that are managed jointly by a single economic entity in a top position. It is also theoretically possible for links to exist between companies that are often informal and not subject to strict legal regulation (Genco, 2014), with dangerous fiscal implications.

Therefore, measures must be taken at the start of the planning stage. Transfer pricing tax planning, part of the global planning activity, includes those activities - which fall within the scope of the tax planning function - that tend to predetermine the allocation of investments, functions and risks of a company in different countries, including the characteristics of the respective tax jurisdictions. The risk in not considering the importance of the investment planning phase is that the company could take on a risky group structure from the fiscal standpoint, a situation that often requires an audit to take place to actually manage risks that are not anticipated in the strategic plans and that only emerge during the implementation phase.

Ultimately, the management of corporate risk, of which tax risk is a part, is a process put in place by all the people involved in whatever way in company management and who contribute to the implementation of winning strategies through the identification of potential critical events that must then be translated into value in the long term (Almici, 2010). A clear tax strategy honed to tax compliance can spur central management to underline the group's contribution to the countries in which it operates, thereby increasing its corporate reputation. In this perspective, tax compliance assumes the character of ethical and social responsibility. In this sense, the framework for the correct, suitable and efficient management of fiscal risk can be represented as follows:



Source: IBFD

The figure clearly summarises what has been said so far: the level of tax risk is partly the outcome of the very tax strategy the group has decided on, and the management of this risk permeates through the entire business operation, thus requiring the active contribution not only of tax departments. To improve the quality of financial, accounting and tax disclosures (Garcia et al., 2010) and to have full control over all tax-relevant information flows, the parent company's Internal Audit must include more and more in its agenda the tax-related issues regarding tax risk management because they are inseparable from the business risk management policies.

##### **5. Internal auditing as a support to the fiscal management of intragroup operations. Future theoretical perspectives**

Management by a single body, through the coordination and control exercised by the parent company, is decisive for multinational groups. The company adopts all the most suitable tools to direct, manage and verify the operating activities, the aim being to ensure compliance with laws, to monitor tax risk and provide true and complete financial and accounting data to all stakeholders. The parent company must monitor various variables that can produce and/or convey tax-relevant information, some from the outside, some from the inside, and other information from the subsidiaries, each with its own reference external environment.

The planning and control function must meet two requirements: on the one hand, the management of external variables and, on the other, the creation of an integrated internal environment in which information is conveyed promptly and knowledge can circulate freely. To cope with the continuous need for knowledge and the increasing volatility of the surrounding environment, it is important that the company's subsystem implements a sound information system. The main task of the information system is to convey knowledge in two directions: both from outside the company to the inside and within the company (from one functional area to another or between the various departments in the company).

Given all the above issues, to obtain better management of the tax risk in transfer pricing there is room for manoeuvre as things stand by intervening precisely on the audit function itself: by improving its effectiveness and performance, by enhancing the role of the internal auditors inside corporate groups and considering them as internal bodies of the parent company responsible for verifying the activities of the subsidiaries (Lemme, 1997). Internal Auditing must stand out essentially for its independence from the corporate management bodies; it must provide advice to improve the effectiveness and efficiency of the organisation (Mariniello, 2010). By fulfilling this



fundamental task, this function improves the corporate governance and generates added value, guaranteeing the stakeholders correct, transparent and knowledgeable management of current and potential risks.

Internal Auditing can help top management in a series of activities, such as identifying and reducing risks and acquiring the necessary information for the process of corporate decision making (Spencer Pickett, 2011). However, it now seems it is necessary to increase the powers of Internal Auditing and enhance the ways it can identify problems in order to put it in a position to prepare a specific project to manage the specific tax risk at an international level. This implementation of the capacity of the function necessarily produces added value for the company, making the company less exposed to the risks of having to pay penalties due to, at the very least, imprudent behaviour by subsidiaries.

The same priorities of knowledge and information are proposed, in fact, during monitoring and control. The analysis and study of internal variables and external interferences must be the prerogative of a "centralised" internal audit function, namely within the parent company, since it is in the ideal position to oversee and supervise the operational profiles of the various legal entities by having a link and constant dialogue with the latter's control systems.

It is standard practice for subsidiaries to adopt their own tax information management procedures for transfer pricing purposes. However, it is believed that this must be done in compliance with the common principles outlined by the parent company. This would facilitate the work of Internal Auditing at a central level, which, however, having a broad and detailed view of what happened and what is happening within the group, is in a position to actively contribute to the achievement and maintenance of solid corporate social responsibility by proposing adequate solutions to the problems encountered and not merely confirming whether the subsidiaries' risk management and internal control systems are structured properly. In this way, auditing would overcome the reductive and simplistic meaning that has been attributed to it over the years, to the extent that it is considered a form of unwelcome interference in the daily activities and whose main purpose is to find inefficiencies and culprits.

This traditional role is also due to the pressure top management usually exerts. The management's emphasis on the need to meet operational and financial objectives can create excessive pressure, which could cause subsidiaries to take on high tax risk. In this case the internal audit function would merely be the instrument used by the holding company to check whether the objectives set for each subsidiary are met or not. The subsidiaries, so as not to disappoint the expectations of the parent company, would operate by taking short-term objectives as their priorities, often neglecting to manage certain variables, such as the fiscal variables, and this would affect the medium and long term. In this regard, one research carried out in the 90s (Gul et Subramaniam, 1994) shows that in those companies with an audit committee, the ability of Internal Auditing to withstand the pressures exerted by the top management is higher than when no internal audit function exists. In relation to the transfer pricing dynamics, moreover, the internal function is in the delicate position of having to mediate between the theoretically divergent expectations of the holding company's management bodies and the expectations of the subsidiaries' control bodies.

The auditors, who do not normally participate in setting the corporate tax strategy, could be asked by central management to endorse aggressive and pathological transfer pricing ideas instead of taking on the role of active promoters of useful and lawful transfer pricing dynamics. In Italy, this filter between the board of directors and the auditing activity (Dittmeier, 2011) is done by the Control and Risk Committee, whose fundamental duty it is to support the board of directors' valuations and decisions in relation to the internal control system and risk management. The first instrument the internal audit function must necessarily use is to acquire the relevant information from all the companies in the group. To do this there must be coordination between peer departments in the individual subsidiaries and an upward information flow so that the parent company is aware of all the aspects of the subsidiaries' fiscal management. The internal auditors of each subsidiary must ensure that the information is correctly by checking that all the data underpinning each audit are correct, exact and complete.

It is therefore necessary to implement a communication system between Internal Auditing that does not remove their autonomy and independence with respect to both the pertinent corporate governing bodies they belong to and the same function in the parent company. It will then be the task of the parent company's audit committee to classify

the information received from all the subsidiaries within defined parameters. This is a delicate phase, given that a connection between the various tax laws will be necessary. It is clear that this step will be very difficult since it is fundamental to the presentation of the data in the company financial statements and reporting, which must be as correct and precise as possible.

In specific cases like the one under examination, an investigation must be carried out into potential or executed fraud in the various group companies, as well as other risk factors, and the results must be given to the pertinent management team and board of directors. To this aim, it must not be forgotten that Internal Audit must be able to notify the public supervisory authorities of any situations under their jurisdiction in a transparent manner. Internal Audit must be empowered to ensure the correct approach to risk management at a group level, at the same time maintaining the necessary coordination with the other control functions, as well as the additional and related responsibility for implementing an assessment process of the internal control system without ever having its independence jeopardised.

#### **6. The tax auditing activity. Possible operational developments**

The management of transfer pricing policies requires Internal Auditing to take on the responsibility to develop the analysis of the business areas covered and the products and services offered<sup>4</sup>, a functional analysis of the group companies, the main intragroup contracts<sup>5</sup>, the distribution policies and, of course, the transactions<sup>6</sup> (both from an economic and financial point of view). The functional analysis consists in completely understanding the functions performed by a given company in the production of a good or in the realisation of a service, considering also the assets used and the accepted risks. The objective is to achieve correct mapping of intragroup transactions. Then the most appropriate method, among those allowed by the OECD<sup>7</sup> and the Financial Administration must be chosen in order to determine the transfer prices.

The group's central departments, with the help of Internal Auditing, must also conduct a quantitative/qualitative analysis to identify, through a progressive skimming process, a sample of comparable companies, in terms of functional and risk profile, and consequently set the levels of market remuneration they have achieved for the activities carried out.

It is indispensable that the tax risk manager does these activities to ensure they are done properly. The tax risk manager's main tasks are to:

- identify, mitigate and control tax risk;
- prevent violations of tax legislation and avoid any tax disputes;
- manage the relationship with the national tax authorities;
- promote joint assessment with the offices of the Tax Authorities on corporate transactions that can be deemed aggressive tax planning schemes;
- notify the tax offices of the tax risks inherent in the group's foreign ownership structures or in the intercompany relations;
- prepare and update the documents related to transfer prices;
- contribute to the intercompany circulation of the "tax compliance culture".

Basically, therefore, tax risk managers are tasked with business intelligence and tax risk management functions and their placement within the company organisation chart must always ensure autonomy and absolute independence. Autonomy must, first and foremost, be understood with respect to the corporate structures responsible for fulfilling

<sup>4</sup>Service performance is one of the most problematic aspects in transfer pricing. Within groups of companies it is frequent to stipulate contracts for the supply of intercompany services and it is not rare to find true "service-companies", a company whose business purpose consists in the performance of services (e.g. legal support, administrative support, etc.). In the operational audit activity, we note that there is not always a contract governing the service, although it is widely known that the existence of written documents bearing a certain date contributes to reducing the risk that the tax authorities will find transfer pricing issues.

<sup>5</sup>Within groups of multinational companies, it is necessary to develop, manage and "maintain" a robust and effective contractual network that reflects the functional analysis carried out and that is constantly updated by Internal Audit.

<sup>6</sup>It is desirable that intercompany transactions are mapped into homogeneous categories:

- sale of goods;
- supply of services (distinguishing those of a financial nature);
- cost sharing agreement (for example, the cost sharing for research activities carried out for subsidiaries which, in view of this, must - logically - pay their fair share of the related costs.

<sup>7</sup> OECD rules recognise the following methods to calculate the price: *Comparable Uncontrolled Price (CUP)*, *Resale Minus*, *Cost Plus*, *Profit Split*, *Transactional Net Margin Method (TNMM)*. The first three are traditional methods based on transactions; the other two are income-based methods based on profit Tax obligations, while independence must be guaranteed above all by the board, namely the body that prepares the group's overall tax strategy. It is therefore essential that the tax risk manager be isolated from pure tax philosophy, which is the exclusive prerogative of the parent company's top management, to ensure the effective line of action is oriented to the real substance of the corporate transactions being monitored

Given the characteristics of the various players involved in the intragroup control, it is believed that this person would naturally fit within the internal audit function, in the hope they will develop a constant dialogue with the tax departments of the various legal entities. Indeed, thanks to this functional position, the person would be in the ideal condition to not only perform the necessary checks, but also to issue the necessary directives or operating instructions, in so doing facilitating interaction with the other company functions. This person is also called on, by their very nature, to "centralise" the tax compliance function, thereby progressively removing this area of activity from the broader compliance function. This will be easier when the department assigned to host the tax risk manager is considered not a mere cost centre but an important revenue centre that can bring value to the business, especially in terms of lost costs.

What has been said about the parent company's Internal Auditing also applies to the same functions in all the group companies, which must be ensured unlimited access to all the company departments, registrations, minutes of all committee meetings, as well as have direct and unlimited access to the board. If the business activities are outsourced, the audit committee must be authorised to have access to information related to these activities. Each of the group's internal audit departments must be able to allocate personnel to the sectors where the risk of transfer pricing is most likely, define objectives and timing and apply the techniques required to achieve the set results. It is extremely important to obtain the support from the employees in the areas being checked. At the end of these activities, the audit results are sent to the appropriate parties as well as to the department at the parent company, with due care not to disclose the information without the necessary authorisation.

## **7. Conclusions**

The creation of value for the stakeholders has, in recent years, become for many companies a real management philosophy in directing operations. As such, we have spoken about value-based management. The thesis that has been sustained in this research is that this new managerial concept applies to every process, including the activities carried out by Internal Auditing. In this context, a stronger auditing role in corporate groups can contribute to giving substance to the management of the overall tax risk, which is all too often only treated from a legal point of view. This study has put forward an economic-business perspective of the problem, offering governance and organisational solutions that can balance the need to optimise distribution in a group of functions and risks with the need to restrict pathological transfer pricing phenomena.

It is believed that the small number of researchers in this particular sector of interest constitutes an academic gap that needs to be filled to improve the tax policies implemented by multinational companies. Taking into account the current economic context in which transfer pricing management, as mentioned, is a useful tool to guide the activities of companies in order to maintain their strong international competitiveness, we have presented the reorganisation



of Internal Auditing as a possible tool to avoid risks connected with the coordination of different company policies in order to direct them to a common and general objective of wellbeing. Without distorting the function, we believe the enhancement of its abilities can create added value for the whole group and instil greater trust in the stakeholders, above all by safeguarding the group from possible tax penalties.

It is hoped there will be coordination and information flow at every level of the audit function, without jeopardising the audit committee's independence and autonomy, which are its peculiar identifying characteristics and main strengths, but which above all allow it to improve its performance.

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