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RISK ANALYSIS AS A FUNDAMENTAL ELEMENT OF THE CAPITAL GROUP'S TRANSFER PRICING POLICY

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Abstract:

The article presents the risk analysis of transactions concluded between related entities as an essential element of the capital group's transfer pricing policy. Risk has been presented as a phenomenon that occurs in every business activity. The importance of its identification for making both operational and strategic decisions by related entities was pointed out. Attention was paid to the significance of verification of potential areas determining the risk in question and ways to limit it. In addition, elements of transfer pricing policy have been presented which should be followed by related entities to limit the negative effects of risk. It was emphasized that creating a transfer pricing policy in the capital group and knowledge of certain tax tools is only a starting point for their proper application, which depends on the assumed goals of the group of related entities and the conditions under which transactions are carried out.

Keywords:

tax law, risk management, transfer prices, transfer pricing policy.

1. INTRODUCTION

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Today, an increasing part of world trade takes place within capital groups. This way of doing business, besides many positive aspects resulting from possible synergy of activities, poses a huge organizational challenge. In addition, the fact that transactions between these entities are subject to the obligation to set prices according to market conditions cannot be ignored.

Issues related to the correctness of determination of the transfer price have become in recent years one of the most important areas of interest for tax authorities around the world. This is due to the need to monitor transactions that may lead to erosion of the tax base. In this respect, related parties, when making decisions on the course of transactions, use specific tools, the application of which makes it possible to limit the risk of setting a price deviating from market principles. One of them is the transfer pricing policy, the aim of which is to properly shape, from the point of view of the company's objectives as well as tax regulations, the rules of executing transactions between related parties. Its crucial element is a properly constructed, logically consistent functional analysis of the transaction, which should in particular take into account the assets involved and the risks incurred by its participants.

The purpose of the publication is to present the essence and scope of the transfer pricing policy, including in particular the risk element in a transaction with an affiliated entity. The article presents the principles of developing this policy. Attention was drawn to the necessity of taking into account not only the conditions of the tax law, but also the organizational conditions resulting from the specificity of the capital group.

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The legal regulations and the literature on the subject lack a comprehensive list of necessary elements of the transfer pricing policy, and the requirement of its possession in particular countries is an obligation imposed by the legislator, e.g. in Poland and the Czech Republic, the fulfillment of which is a practical problem for capital groups. These issues have been linked to an element of risk borne by affiliated entities. Moreover, the article proposes a solution for determining its amount by the participants of the transaction. The article uses research methods such as literature studies and analysis of accounting documentation of capital groups.

2. THE ESSENCE OF TRANSFER PRICING POLICY

The transfer pricing policy is a tool that defines the action in the field of transactions with affiliated entities, determined by the decision center, aimed at achieving the objectives of the capital group as a whole through the transfer of goods between these affiliated entities. These objectives should be primarily consistent with the superior arm's length principle. Therefore, it can be concluded that the transfer pricing policy is one of the management tools between the affiliated entities for the accomplishment of certain objectives and tasks of a higher degree while maintaining the arm's length principle.

Its primary role is to properly present the existing relations within the capital group, identify added value chains and present the methods of calculating the remuneration received as part of intra-group transactions.(Stone i in., 2020) It is worth emphasizing that the transfer pricing policy does not have to have a formalized form, e.g. in the form of a prepared document. These can only be verbal arrangements determining the rules of the transaction. However, some of the authors, e.g. J. Mika, claim that due to the fact that it is a basic tool that can be used to manage transfer pricing risk in a group of affiliated entities, it is appropriate to develop it in a formal manner.(Mika, 2019) Moreover, such a document should contain information concerning, among others, the way of documenting transactions, information on data circulation in the group, assignment of specific tasks concerning transfer pricing risk management by particular entities, verification and control of adopted assumptions, compliance of transfer pricing with tax regulations. It should be noted that the guidelines concerning the content of the transfer pricing policy were included in BEPS reports. The issues concerning the relation between the process of creating added value in the group and the transfer pricing policy have been defined primarily in Actions 8-10

It should be emphasized that the intention of the transfer pricing policy is, from the point of view of the company's objectives, as well as tax regulations, appropriate shaping the principles of transactions between affiliated entities, carried out through the following processes:

- standardization of the transaction execution process,
- standardization of the valuation of asset or benefit transfer, and,
- standardization of principles and rules for control of transaction execution.(Stamblewska-Urbaniak & Zbroiński, 2019)

The implementation of the indicated processes rests with the person the transfer pricing policy is addressed to, in particular the management of the capital group, the management of individual related entities, the staff of financial departments (divisions), the staff of operational departments (divisions) and the staff of human resources management departments.(Kaniewska-Środecka, 2018)

Undoubtedly, depending on whether the capital group functions as an operating, management or financial group, the scope of standardization of transfer pricing principles in the transfer pricing policy may vary. Greater transparency of operations can be expected in an operational capital group, which will result in detailed price calculation methods and applied margins. In the management and financial group, due to greater autonomy of companies' operations, as well as the desire to protect business secrets, there may be greater resistance to disclosure of the principles of calculation and determination of margins in transactions. A similar relationship exists with regard to the functional profile of related parties. It results from the fact that distributors with developed functions, being in the central division of the capital group, may oppose the imposition of pre-defined margins.(Jost i in., 2014) In such cases, the transfer pricing policy should refer to internal pricing procedures established by the subsidiaries. Furthermore, for the parent company, individual entities may act as centers of responsibility. This dependence is visible in vertically organized capital groups, where manufacturing entities act as contract manufacturers or toll manufacturers. In such a situation, the parent company acts as a unit setting and imposing prices in transactions.(Kabalski, 2001)

The scope of this policy should include a description of the course of the transaction from the moment of its planning to the stage of final development of transfer pricing tax documentation. An example of its scope of information on the basis of legal regulations in force in Poland is presented in table 1.

Table1. An exemplary scope of information included in the transfer pricing policy of the capital group.

Transfer pricing policy element	Entity obliged to establish principles of transfer pricing policy	The entity obliged to the application of transfer pricing policy principles	Comment
Transfer pricing policy objectives	Parent company	Parent company, affiliated entities	The objective is, among others, to verify on an ongoing and continuous basis the risk of questioning the validity of the established transfer pricing.
Legal regulations	Parent company	Affiliated entities	It is essential to continuously monitor and analyse changes in national legislation and OECD guidelines.
Capital structure of capital group	Parent company, affiliated entities	Parent company, affiliated entities	The recommendation is to create an organigram presenting the structure of the capital group.
Identification of value-added chains	Parent company, affiliated entities	Parent company, affiliated entities	In this respect, the key value-added chains that exist, i.e. those with a revenue of at least 5% of the group's revenue, should be indicated.
Characteristics and objectives of activities of entities in the group	Parent company, affiliated entities	Parent company, affiliated entities	Both the parent company and the affiliated entity should constantly provide information on the updated nature of the activities undertaken.
Principles of identification of affiliated entities	Parent company, affiliated entities	Parent company, affiliated entities	It is necessary to implement an order for each verification of the relationship between the participants in the ransaction and to immediately provide information in this respect to the dedicated entity or other entities in the group.
Principles of identifying transactions in the capital group	Parent company, affiliated entities	Parent company, affiliated entities	A separate agreement should be drawn up for each transaction.
Principles of performing functional analysis of the transaction	Parent company, affiliated entities	Parent company, affiliated entities	Functional analysis is a synthesis of three analyses: analysis of functions performed, analysis of assets engaged and analysis of risks involved.
General principles of establishing transfer pricing in transactions	Parent company	Parent company, affiliated entities	Each time it is necessary to check whether the established price is consistent with market principles.
Principles of preparation benchmarking	Parent company	Parent company, affiliated entities	It should be determined how to obtain comparative data.
Creation of a schedule of activities related to reporting on transfer pricing	Parent company, affiliated entities	Parent company, affiliated entities	The deadlines for the preparation of documentation and tax declarations should be specified, along with the schedule for their submission to the tax administration.
Principles of intra-group communication	Parent company, affiliated entities	Parent company, affiliated entities	Rules should be established for providing the circulation of information needed to prepare transfer pricing tax documentation.

Source: Own elaboration based on:(Sulik-Górecka, 2018)

It is worth noting that the organizational effort made to prepare a coherent transfer pricing policy allows to achieve measurable effects in the form of an efficient transfer pricing system. Moreover, it should be stressed that due to the complexity and variability of the economic environment, it is not possible to cover all possible circumstances in the policy in question. Therefore it should be constantly assessed in terms of its validity and usefulness.

3. RISK AS PART OF TRANSFER PRICING POLICY

One of the key elements of the transfer pricing policy is the need to conduct a functional analysis, including the risks incurred by the parties to the transaction. This aspect should not be omitted by business entities, as it constitutes a component determining the amount of remuneration fixed by affiliated entities.

In the case of this element, the transfer pricing policy should include a detailed description of the risks taken by the parties to the transaction. The presented distribution of risk between the participants of the transaction should be as close as possible to the one between entities on the independent market. In this respect, with reference to the BEPS Action Guidelines 8-10 proposed by the OECD countries, it is indicated that it is appropriate to reflect the supply chain course of the transactions and to allocate profit or loss to the entity that has incurred the risk. The emphasis is placed on the actual conduct of the transaction participants, and then the provisions of the agreement concluded between the parties are analysed. (OECD, 2017)

This is because, in the case of cross-border transactions, risk can be transferred by defining imaginary functions of entities. In this respect, the OECD guidelines indicate that a risk analysis will not be complete unless a comprehensive functional analysis of the transaction is carried out. Therefore, it is fundamental that the description of risk in the transfer pricing policy should include issues of how the risk is distributed among the participants of the transaction, their functions and the results of anticipated events that may potentially occur in connection with the execution of a given transaction. In this respect, the OECD guidelines propose to conduct a risk analysis in the so-called six steps. These are presented in table 2.

Table 2. Risk analysis of economic operations proposed by the OECD

	Description
Step 1	Identification of economically significant risks
Step 2	Analysis of the content of the agreement and indication of the risks transferred in the transaction
Step 3	Performing a functional analysis, determining the actual risk management and determining which of the entities controls the risk, accepts the beneficial and negative effects of its materialization.
Step 4	Interpretation of the obtained analysis results and their confrontation with the actual state determined by the actual behaviour of the entities and the financial capacity of the entities to incur a given risk.
Step 5	Allocation of risk to an entity which controls it and has sufficient financial capacity.
Step 6	Performing valuation of the transaction taking into account properly allocated risk and functions performed during its control.

Source: Own elaboration based on:(OECD, 2017)

The identification of risk and the response to it should be verified on a case-by-case basis. Sometimes assigning participants to the management function of a specific risk will not result in a thorough analysis, as some of them result from the nature of the transaction. In addition, when a specific risk occurs, both the negative and positive effects of its materialization should be considered. Sometimes, it is appropriate to apply a solution consisting in risk management and control by an external entity. In such a case, this entity decides to perform functions concerning its limitation and monitoring within the scope of the received order.

Transaction participants who incur its risk should also have appropriate experience and competence in this matter. In addition, it is closely related to obtaining the necessary information that will allow them to estimate the risk. It should be emphasized that risk control should not be reduced to the direct implementation of a specific action each time, as failure to respond to a given risk may constitute a fully conscious decision that allows for the creation of a favorable financial result.

Nevertheless, entities deciding to implement economic activities must bear in mind that events causing certain threats will be a critical element. As a consequence, the materialization of excessive risk may result in the failure to achieve the objectives set. Therefore, it is important to verify the risks which have a significant impact on the financial condition of the entities, as it is they who may modify the business objectives set by the affiliated entities.

Moreover, in the scope of planned transactions, affiliated entities, when analyzing the content, should divide the risks into those arising directly from the agreement and those that can be predicted based on the interpreted facts specified in the agreement.(Cecchin i in., 2013) An example of a situation where the assumption of a specific risk is appropriate is when the participants of an agreement set payment dates depending on receiving remuneration of one of the participants from another entity in the supply chain. The risk assessment in this respect should be carried out ex ante.

It should also be borne in mind that the appropriate allocation of risk affects the pricing aspects of the agreement. The importance of this issue can be observed when an entity transfers the risk to the buyer as a result of fluctuations in raw material prices. In comparison with the case when an entity decides to bear the risk in its entirety, it should be considered that it may agree to make a lower profit.(Kosieradzki i in., 2019)

With these issues in mind, it should be considered that aspects verifying the risk incurred in a transaction should be included in the transfer pricing policy. These issues require a thorough rethinking by those who enter into transactions on an international scale and continuous monitoring of their relevance to the circumstances. Although risk is only one of many elements influencing the amount of the transaction price, omitting it may distort its correct estimation.

4. DETERMINING THE AMOUNT OF RISK INCURRED BY AFFILIATED ENTITIES - CASE STUDY.

As indicated above, carrying out a risk analysis should be a critical element of transfer pricing policy. For its proper allocation in a transaction, the so-called responsibility assignment matrix (also called the RACI matrix). (Jacka & Keller, 2009) This matrix is formed by an acronym indicating four aspects that should be taken into account in the analysis by economic operators:

- **Responsible** – responsible for performing a specific task,
- **Accountable** – supervising the correctness of project implementation,
- *Consulted* – counselling other entities participating in the project,
- **Informed** – having information about the execution of the project, but at the same time having no direct influence on the decisions made.

The RACI matrix is one of the proposals to determine the risk incurred by the parties to the transaction. Its applicability, purpose and design is presented on the example of entities A and B, which entered into an agreement to jointly develop a new product.

In the initial stage of the project, entities A and B established three main processes and matching sub-processes. Next, appropriate weights were assigned, thus illustrating the key activities for the success of the project.

Table 3. Weights of processes and sub-processes.

	Weights for process factors	**40%**	**25%**	**35%**	
Main process	**Sub-process**	**Project management**	**Computerization**	**Supply logistics**	**Weights of subprocesses**
R&D activity	Development of the concept	10%	3%	1%	14%
	Designing the prototype	5%	3%	0%	8%
	Implementation support	10%	0%	0%	10%
Production	Preparation of the machinery stock	5%	6%	5%	16%
	Organisation of raw material supply	0%	3%	10%	13%
	Component production	2%	3%	4%	9%
	Prototype quality control	3%	1%	2%	6%
After-sales service	Customer acquisition	0%	1%	6%	7%
	Settlement of product distribution to customers	0%	3%	5%	8%
	Product certification	5%	2%	2%	9%
Summation		**40%**	**25%**	**35%**	**100%**

Source: Own elaboration

The classification presented above allows to adjust the weight to a specific sub-process. In the next stage, the RACI matrix is constructed, whose intention is to relate activities defined as a sub-process to entities A and B. For this example, the RACI weights are assigned according to the following digital designations, i.e. **R-4, A-3, C-2, I-1.**

Table 4. Assignment of weights for entities A and B.

Main process	Sub-process	R	A	C	I	Weight A	R	A	C	I	Weight B
R&D activity	Development of the concept	4	0	0	0	**80%**	0	0	0	1	**20%**
	Designing the prototype	4	0	0	0	**67%**	0	0	2	0	**33%**
	Implementation support	4	0	0	0	**67%**	0	0	2	0	**33%**
Production	Preparation of the machinery stock	0	0	2	0	**33%**	4	0	0	0	**67%**
	Organisation of raw material supply	0	0	2	0	**33%**	4	0	0	0	**67%**
	Component production	0	0	0	0	**0%**	4	0	0	0	**100%**
	Prototype quality control	0	0	0	1	**20%**	4	0	0	0	**80%**
After-sales service	Customer acquisition	4	0	0	0	**57%**	0	3	0	0	**43%**
	Settlement of product distribution to customers	4	0	0	0	**57%**	0	3	0	0	**43%**
	Product certification	4	0	0	0	**57%**	0	3	0	0	**43%**

Source: Own elaboration

Then, a comparison is made of the obtained RACI weights belonging to the sub-process weights of the obtained weights presented in the last column of table 4. The obtained results present the profit distribution reflecting the functional analysis of the transaction chain by the participants of the transaction. It is worth noting that this is not a profit distribution defined as a transfer pricing calculation method.

Table 5. Determination of shares between entities A and B.

Main process	**Weights for process factors**		
	Sub-process	**Share of entity A**	**Shre of entity B**
R&D activity	Development of the concept	**11%**	**3%**
	Designing the prototype	**5%**	**3%**
	Implementation support	**7%**	**3%**
Production	Preparation of the machinery stock	**5%**	**11%**
	Organisation of raw material supply	**4%**	**9%**
	Component production	**0%**	**9%**
	Prototype quality control	**1%**	**5%**
After-sales service	Customer acquisition	**4%**	**3%**
	Settlement of product distribution to customers	**5%**	**3%**
	Product certification	**5%**	**4%**
Summation		**47%**	**53%**

Source: Own elaboration

The above example shows the distribution of risk between the parties to the transaction. Therefore, the RACI matrix is one of the solutions that allows to present the way of its allocation. As far as the issue of the risk assessment is concerned, it should also be borne in mind that the party managing the risk may bear the highest costs of its materialization. In this respect, however, as a result of undertaking risk control, it should also be adequately remunerated for it. Moreover, it should be noted that the risk element is an essential aspect for the construction of an appropriate business strategy by related parties, as it determines the transaction price.

5. CONCLUSION

The proper management of intra-group transactions is an issue which all members of a given capital group should be responsible for. Any weakness in this respect results from a failure to ensure adequate accountability, strategy and transparency in the proper setting of intra-group transaction conditions. The growing interest of tax authorities in transfer pricing issues means that capital groups should demonstrate greater discipline, better internal control and accountability. Failure to comply with existing and emerging laws and regulations may pose a threat to the business activities of entities and increase the risk in the area of tax sanctions. Businesses should take into account existing risks related to non-market conditions of intra-group transactions. Entities that apply non-market prices or do not have proper tax records are exposed to the risk of upward adjustment of income from intra-group transactions. The above risks mean that in many companies, having a transfer pricing policy and procedures for managing intra-group transactions becomes a tool for the maximum reduction of tax risk, and also allows for consistent management of intra-group transactions. Therefore, the transfer pricing policy is becoming for entrepreneurs an increasingly important element in the process of determining the terms of intra-group transactions. One of the elements of the transfer pricing policy is the indication of the risk incurred by the parties to the transaction. Its incorrect definition may affect the overall results of the functional analysis, which cannot be ignored when calculating the transaction price.

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7. LITERATURE

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