Tax Compliance Control and Audit of Transfer Pricing Transactions

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Abstract*. The article presents the authors' vision of the features and mechanism of tax compliance control and audit in the management of transfer pricing operations. Effective interaction between business entities and tax authorities in the process of controlling and auditing transfer pricing transactions should be based on the principles of compliance with the help of two tools – assessment of the quality of transfer pricing policy and internal control system (as a result of interaction of internal and external control systems) and assessment of the quality and effectiveness of internal audit of transfer pricing (as a result of interaction of internal control and audit systems). In accordance with the above, tax compliance control and audit becomes a new element of the established system of monitoring of controlled transactions of a business entity, which proposed to understand as the use of tools to confirm the quality and effectiveness of internal control and audit systems of transfer pricing transactions of a business entity by a tax authority, which certifies the taxpayer's commitment and responsibility to comply with tax legislation in terms of compliance with the arm's length principle. Confirmation by the tax authorities of the quality of the transfer pricing policy and internal control and audit system of the entity should be based on the developed, tested and approved system of assessment parameters. Confirmation of the assessment of the quality of the transfer pricing policy and internal control system will demonstrate the responsible position of the taxpayer based on tax compliance with the transfer pricing legislation in accordance with the arm's length principle and will increase the level of trust in it on the part of the tax authorities. In turn, the introduction of such a tool as an internal transfer pricing audit quality assessment into the process of monitoring-controlled transactions will allow the company to submit and use the results of its internal audit in assessing transfer pricing risks to form its tax rating and assess the need to include it in the audit plan. This tool assumes that the internal audit system is sufficient to timely detect violations of tax legislation in the field of transfer pricing in accordance with the arm's length principle.*

Keywords**:** *transfer pricing, controlled transactions, arm's length principle, tax control and audit, tax compliance.*

JEL Classification: *E64, F23, F65, H25, H26, H32, K34*

1 Introduction

Interaction between business entities and tax authorities in the process of tax control and audit of transfer pricing transactions is usually accompanied by an increasing level of tension, unwillingness of business entities to facilitate the procedures for verification of tax legislation in terms of compliance of controlled transactions with the arm's length principle, distrust of tax authorities to certain entities conducting such transactions, which is quite reasonable given the practice of using transfer pricing. All these factors can eventually lead both business entities and tax authorities to resolve controversial aspects in court, as evidenced by a significant number of court cases and lawsuits (Review of the case law of the Administrative Court of Cassation within the Supreme Court on transfer pricing, Review of the Supreme Court's

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case law in transfer pricing and international taxation). Accordingly, it should be noted that the system of interaction between business entities and tax authorities in the process of controlling and auditing transfer pricing transactions should be improved based on tax compliance. The transfer pricing documentation, the practice of concluding agreements on preliminary pricing, and the survey of business entities in the process of monitoring-controlled transactions (Kraievskyi & Muravskyi, 2023; Myskin, Skoryk, & Paranytsia, 2024; Tytenko & Bohdan, 2020) are the first steps towards the development of partnerships between business and tax authorities in the field of compliance with tax legislation on transfer pricing and avoidance of double taxation. At the same time, it is advisable to develop a system of the following elements and tools of interaction.

The purpose of the article is to develop a conceptual framework for tax compliance control and audit techniques for transfer pricing transactions as a basis for building a qualitatively new level of relations in the system "business entities – tax authorities". The achievement of this goal will be based on the conclusions obtained within the framework of the research objectives, namely:

– To identify and define the nature of interaction between business entities and tax authorities in the process of tax control and audit of transfer pricing transactions based on tax compliance;

– to form a mechanism for assessing the quality of the transfer pricing policy and internal control system;

– to propose directions for using the assessment of the quality and efficiency of the internal audit system of transfer pricing.

The methodological basis for understanding the object of study was the postulates of the theory of systemic problem solving the systemic approach was implemented. The following methods were used in the course of the study: structuring – in the process of developing a system of interaction between business entities and tax authorities in the process of tax control and audit of transfer pricing transactions on the basis of tax compliance; component analysis – in the process of developing a system of quality metrics for the company's transfer pricing policy and internal control system; graphical – in the process of visual presentation of the study materials.

2 Interaction Between Business Entities and Tax Authorities in the Process of Tax Control and Audit of Transfer Pricing Transactions

The proposed system of interaction between business entities and tax authorities in the process of tax control and audit of transfer pricing transactions is shown in Figure 1.

Thus, effective interaction between business entities and tax authorities in the process of controlling and auditing transfer pricing transactions should be based on the principles of compliance with the help of two tools – assessment of the quality of transfer pricing policy and internal control system (as a result of interaction of internal and external control systems) and assessment of the quality and effectiveness of internal audit of transfer pricing (as a result of interaction of internal control and audit systems). In accordance with the above, tax compliance control and audit becomes a new element of the established system of monitoring of controlled transactions of a business entity, which is proposed to be understood as the use of tools to confirm the quality and efficiency of internal control systems and audit of transfer pricing transactions of a business entity by the tax authority, which certifies the taxpayer's desire and responsibility to comply with tax legislation in terms of compliance with the arm's length principle. Let's take a closer look at each of the proposed instruments.

3 Assessment of the Quality of the Transfer Pricing Policy and Internal Control System

Assessment of the quality of the transfer pricing policy and internal control system is a confirmation by the tax authorities of the quality and effectiveness of the company's transfer pricing management system, including the status and quality of internal control processes. The transfer pricing policy developed by the company (or its business unit) should reflect and duly confirm the functioning of the system of management and control of transfer pricing transactions based on tax compliance.

Confirmation by the tax authorities of the quality of the transfer pricing policy and internal control system of the entity should be based on a developed, tested and approved system of assessment parameters. The development and implementation of such a tool may be within the functional responsibilities of a tax authority created within the structure of international taxation and transfer pricing departments. Accordingly, this body will be responsible for conducting and confirming the assessment of the quality of the transfer pricing policy and internal control system of the business entity. It may be debatable whether this function should be performed by a department within the tax authority, or whether an official authorised to perform this function is sufficient. In the process of establishing such an interaction tool and testing it, an authorised official is sufficient, and in the case

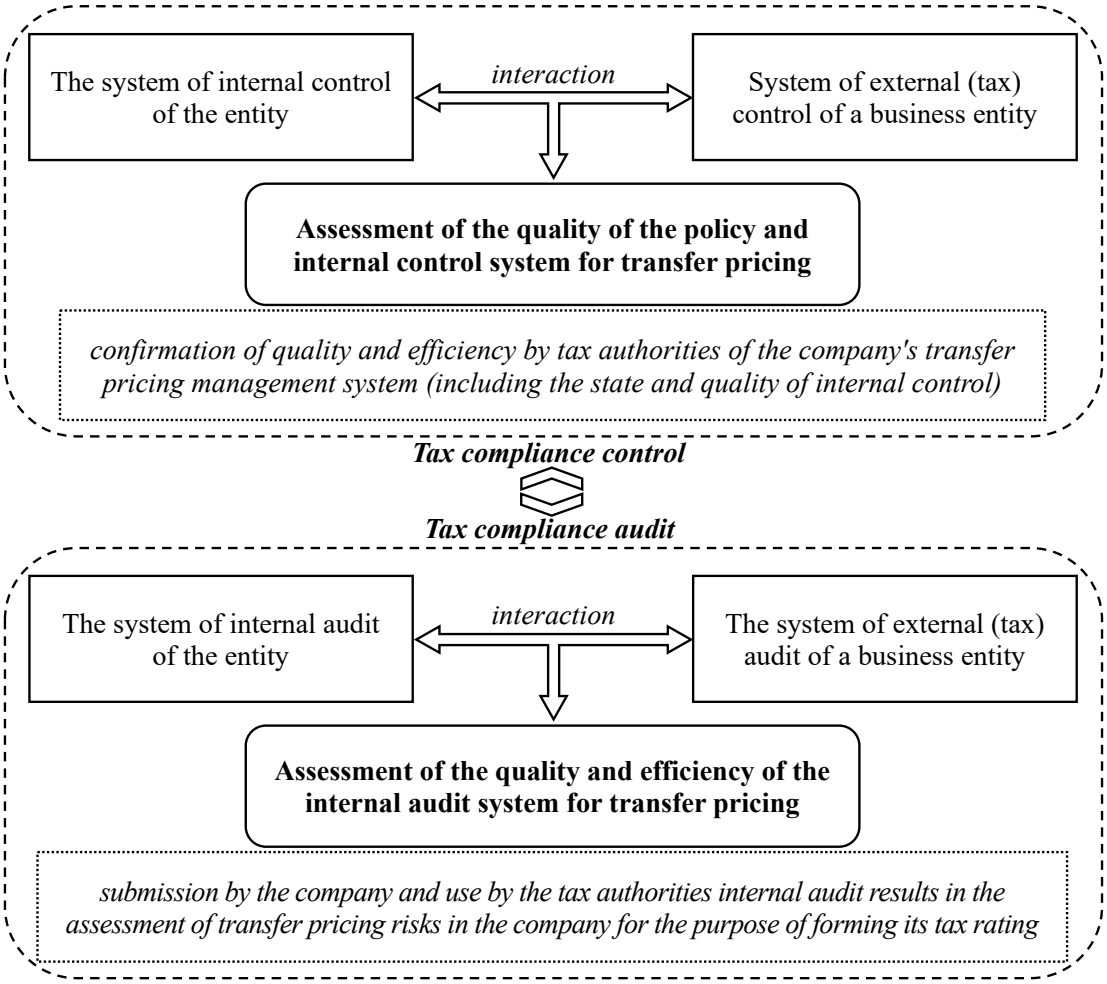


Figure 1 The system of interaction between business entities and tax authorities in the process of tax control and audit of transfer pricing transactions based on tax compliance

Source: compiled by the authors

of scaling up, the organisational structure may be revised.

The process of assessing and confirming the quality of a business entity's transfer pricing policy and internal control system can be represented by the following stages (Figure 2).

The process of assessing and confirming the quality of the company's transfer pricing policy and internal control system begins when the person (specialist) authorised to perform the relevant functions or a structural unit of the tax authority receives the company's request.

From the moment the request is registered, the relevant specialist prepares documentation for the assessment of the company's transfer pricing policy and control system, which includes the following data:

1. General information about the business entity and its "tax history" in the field of transfer pricing, namely:

– Constituent information about the entity, the nature of the relationships with related parties;

– the value and types of controlled transactions for the last 5 years (with details by country, counterparties, etc.);

– results of monitoring of controlled transactions by the tax authorities, the extent of independent adjustments to the tax base;

– transfer pricing risk level and tax rating of the entity;

– results of audits of transfer pricing documentation.

2. Programme documents of the process of assessing the quality of the transfer pricing policy and internal control system, namely:

– Visit programme, list of questions for the study, list of documents to be submitted by the company;

– an evaluation sheet with pre-approved quality metrics for transfer pricing management processes and internal control system;

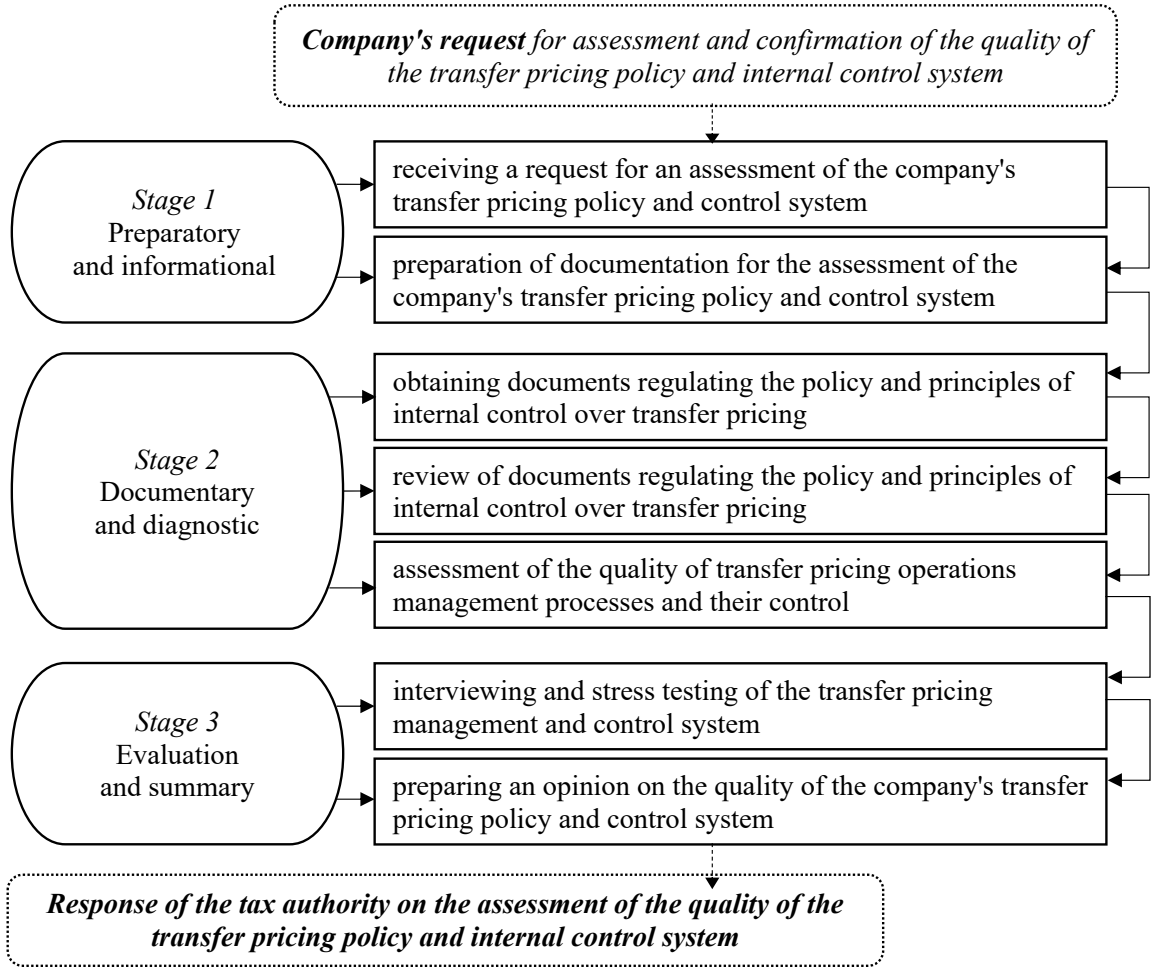


Figure 2 The process of assessing and confirming the quality of the company's transfer pricing policy and internal control system

Source: compiled by the authors

– a questionnaire for employees involved in transfer pricing management and control;

– a list of tasks for the stress test of the transfer pricing management and internal control system.

3. A form of conclusion on the assessment of the quality and compliance of the transfer pricing policy and internal control system.

The first block of documentation is for reference for a specialist assessing the quality of the company's transfer pricing policy and internal control (all the above information will be contained in the company's tax profile). Its informational purpose is to provide general information about the object of assessment, determine the scale and scope of controlled transactions, its reputation and integrity. Certain controversial points of the first block of documentation may affect the final decision on the assessment of the quality and compliance of the transfer pricing policy and internal control, but they are not decisive at the same time.

The second block includes documents intended to ensure the assessment of the company's transfer pricing policy and internal control.

As for the evaluation letters with pre-approved quality metrics for transfer pricing management processes and internal control system, staff questionnaires and a list of stress test tasks, let us consider them in more detail.

The quality metrics of the transfer pricing management policy and its internal control are indicators that show the level of quality and appropriateness in the management of the relevant operations. It is believed that the system of quality metrics for a company's transfer pricing policy and control should be based on the SMART concept. That is, the objectives of the creation and operation of such a system should be: specific, measurable, achievable, realistic and time related. This approach will create conditions for a qualitative and objective assessment of the transfer pricing policy and internal control system.

The list of quality metrics for the transfer pricing policy and internal control system is presented in Table 1.

It should be noted that the list of Quality Metrics of the company's transfer pricing policy and internal control system is not exhaustive, but rather debatable, and is of scientific and practical interest for its content and improvement. It is deemed appropriate to explain the metric related to the delineation of roles in the business processes of registration, analysis and control of transfer pricing transactions, since its value (state) will affect one of the stages of the assessment. The target value (state) of this metric is the availability of a RACI matrix with a clearly defined distribution of functions and participants in the process of managing transfer pricing operations by role. A specialist in assessing the quality of the company's transfer pricing policy and internal control system can use this matrix to compare the provisions of internal regulatory documents with the business model of processes, their owners and participants. In particular, the RACI responsibility matrix will create the conditions for conducting a survey of employees and a general stress test of the company's transfer pricing system.

Table 1 Quality Metrics of the company's transfer pricing policy and internal control system

№	Group of metrics / indicators	The value of the indicator (system status)	
		Basic	**Targeted**
1. General policy for managing transfer pricing transactions			
1.1	Current regulatory framework and internal documents on transfer pricing	available	digitised
1.2	Transfer pricing regulations/policy (document) developed and adopted at the company level	available	available, under review
1.3	Developed a business model for the processes of transfer pricing registration, analysis and control	available	available, under review
1.4	Delineation of roles in the business processes of registration, analysis and control of transfer pricing transactions	available in job descriptions	available (according to the RACI matrix)
1.5	Functioning of the transfer pricing management information system (module)	available	available, digitised
2. Identification and assessment of transfer pricing risks			
2.1	Approved methodology for identifying, assessing and managing transfer pricing risks	available	available, under review
2.2	Determining the risk level of a company's transfer pricing transactions	manually	digitised
2.3	Reports on the results of transfer pricing risk assessment and plans to address them	available	available, digitised
3. Preventive and post-transfer pricing control			
3.1	Planning and participation in the process of transfer pricing transactions	existing plan	plan and register in place
3.2	Regulations for ensuring control and participation in transfer pricing processes	available	available, under review
3.3	Cases of preventing violations of tax legislation in the field of transfer pricing	available	available, documented
4. Communication and reporting in the transfer pricing control system			
4.1	Internal and external communications in the process of controlling transfer pricing transactions	formally	defined by the document
4.2	Assessment of communication maturity and efficiency in transfer pricing control processes	formally	defined by the document
4.3	Application of digital technologies in the control of transfer pricing transactions	fragmented	comprehensively
4.4	Assessment of the operational effectiveness of internal control over transfer pricing	fragmented	comprehensively
4.5	Reporting on the effectiveness of the internal control system for transfer pricing operations	available	available, digitised

Source: compiled by the authors

The purpose of the process of interviewing the employees responsible for managing and controlling the company's transfer pricing is to verify the qualifications and their compliance with the functions performed (assigned), knowledge of transfer pricing legislation and internal communication channels. For this stage, a questionnaire may also be developed for an individual employee (legal, accounting or other department) involved in the business processes of processing, analysing and controlling transfer pricing transactions. The questions in the questionnaire may relate to current changes in tax legislation in the field of transfer pricing, checking the level of "ownership" of a business process area, approaches to interaction with other areas, etc.

The stress test stage of the transfer pricing policy and internal control system is intended to create a "failure" of one of its parts for an established business process in order to assess the response and "stress resistance" of the management system. The stress test is an appropriate and timely response that will allow, if necessary, to correct "failures" in the transfer pricing management business process based on expert and constructive opinion at the internal level. Stress testing becomes even more relevant given the combination of resources that companies use to cover their transfer pricing, whether internal or blended with specialised professionals or firms, and the different cases that can arise from these combinations. The stress test requires independence of judgement with respect to the case under analysis. Consider, for example, a stress test for an external tax audit. The transfer pricing manager should put himself or herself in the shoes of a critical tax inspector and review and identify, both in the information disclosed and, in any omissions, the weaknesses of the subject of the audit, creating opportunities to improve the procedure used or the documentation submitted or to be submitted to the tax authorities. In addition, companies can conduct a stress test on their own using one of the following approaches:

1) reviewing the objectives of SMART-based processes as part of the continuous improvement process for professional transfer pricing teams with sufficient internal resources to perform their actions and functions, so that critical phases and business processes are constantly monitored to achieve results that meet the mandatory professional quality metrics of transfer pricing policy and internal control;

2) outsourcing the functions of improving the management and control of transfer pricing operations, which will allow an objective assessment of the adequacy of the organisation of business processes based on the SMART concept to understand how the responsible employee should respond to failures in the management of the transfer pricing process.

The stress test of the system of management and control of transfer pricing operations can be carried out based on a schematic diagram (Figure 3).

The results of the stress test of the company's transfer pricing management and control system are important for the tax authority's specialist in assessing the quality of this system, as they determine the resource and competence sufficiency and effectiveness.

Based on the results of the preliminary study of the object, assessment of the quality of the transfer pricing policy and internal control, stress test and, if necessary, additional interviews with the staff, the assessor prepares a reasoned conclusion on the confirmation by the tax authority of the quality and effectiveness of the company's transfer pricing management system (including the state and quality of internal control). Such confirmation (in the form of a certificate, a certificate or an entry in the tax profile of the business entity) will demonstrate the taxpayer's responsible position based on tax compliance with the transfer pricing legislation in accordance with the arm's length principle and increase the level of trust in it on the part of the tax authorities.

4 Assessment of the Quality and Efficiency of the Internal Audit System for Transfer Pricing

The second tool for interaction between business entities and tax authorities in the process of tax control and audit of transfer pricing transactions based on tax compliance, which arises from the results of interaction between internal and external (tax) audit systems, is the assessment of the quality and efficiency of the internal audit system of transfer pricing in the company. It is implemented through the submission by the company and use by the tax authorities of the internal audit results in assessing transfer pricing risks in the company to form its tax rating and assess the need to include it in the audit plan.

This tool assumes that the internal audit system is sufficient to timely detect violations of tax legislation in the field of transfer pricing in accordance with the arm's length principle. Internal audit reports can be used by the tax authorities in the process of monitoring-controlled transactions and influence the final decision on the audit of the company.

The internal audit of transfer pricing transactions may be carried out by the parent (holding) company to minimise the risks of tax

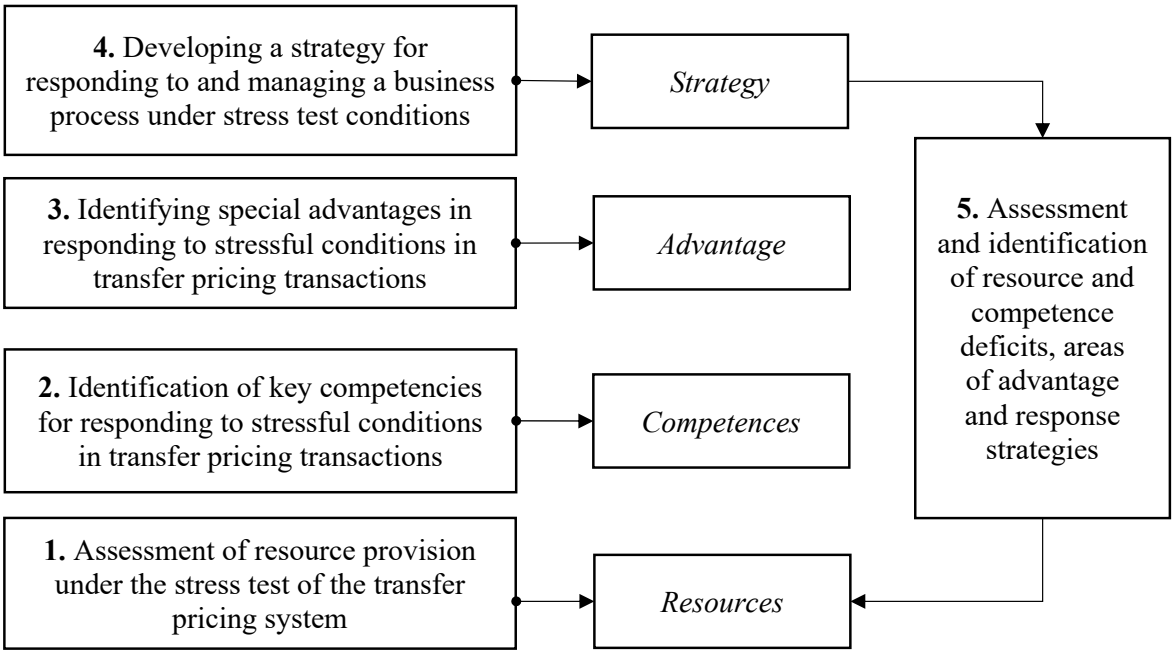


Figure 3 Stress test scheme for the company's transfer pricing management and control system

Source: compiled by the authors

law violations by the company's separate business units. It is standard practice for business units to adopt their own procedures for managing tax information for transfer pricing purposes. However, as was mentioned above, such policies should be implemented in accordance with the established regulations at the parent company level. This would facilitate the work of the internal audit function at the parent company level, which, having a broad and detailed view of what has happened and is happening within the business units, can actively contribute to achieving and maintaining strong corporate social responsibility based on tax compliance and balancing stakeholder interests by proposing adequate solutions to problems that have arisen, rather than simply confirming whether the management systems of the business units' transfer pricing operations are properly structured.

In this way, internal audit can, on the one hand, avoid the "label" that has been attached to it for many years, as it was considered a form of unwanted interference in business activities and the main purpose of which was to find inefficiencies in decisions made, their non-compliance with the law and identify those responsible for such violations, and, on the other hand, build a reputation and increase the level of trust on the part of tax authorities of different countries in relation to both business units and the international group of companies.

The process of internal audit of transfer pricing transactions of business units carried out by the parent company should be carried out in the following sequence:

1) obtaining relevant information on internal audits from the group's business units. This requires coordination between the internal audit functions of the business units and the centralised internal audit function of the parent company;

2) classification of information received from all business units of the group of companies within the defined parameters;

3) if the internal audit departments of business units or the parent company detect violations of tax legislation in the field of transfer pricing, the parent company must notify the tax authority of the state under whose jurisdiction the business unit that committed the violation of the law is located.

Internal audit should have the authority to ensure that the risk management approach is appropriate at the group level, while maintaining the necessary coordination with other control functions, and the additional responsibility to implement a process for evaluating internal audit results, without ever compromising its independence. The management of transfer pricing policies requires internal audit to take responsibility for developing the analysis of the scope of activities, functional analysis of the group's business units, major intra-group contracts, allocation policies and the transactions themselves (from both an economic and financial perspective). The parent company's internal audit function should also perform a quantitative and qualitative

analysis, using appropriate procedures, to identify, through a gradual process of attrition, a sample of comparable companies in terms of functional and risk profile.

In order to regulate the assessment of the quality and efficiency of the internal audit system of transfer pricing and the further use of internal audit materials in the process of monitoring controlled transactions of a business entity, a memorandum of understanding should be concluded between the tax authority and the taxpayer (represented by the parent company of an international group of companies) on assistance in compliance with tax legislation in the field of transfer pricing regarding the compliance of the transactions with the arm's length principle. This memorandum will form the legal basis for the transfer of internal audit materials on transfer pricing transactions to the tax authorities. In this context, the Procedure for Monitoring of Controlled Transactions (Procedure for monitoring controlled transactions, 2015) needs to be supplemented with the relevant provisions, namely:

"3. Monitoring is carried out by:

analysing the materials of internal audit of controlled transactions of the taxpayer (in accordance with the concluded memorandum on assistance in compliance with tax legislation in the field of transfer pricing regarding the compliance of the transactions with the arm's length principle...".

In addition to the materials of the internal audit of controlled transactions, the company may additionally provide an action plan (recommendations) to eliminate the identified deficiencies, supporting documents to eliminate the identified deficiencies (including independent adjustments to the tax base).

Thus, the use of tax compliance techniques in the form of tools for assessing the quality of transfer pricing policy, internal control and internal audit allows us to conceptualise a model of tax control and audit of transfer pricing transactions based on compliance (Figure 4).

5 Conclusion

Thus, the effective interaction of business entities and tax authorities in the process of controlling and auditing transfer pricing operations should be based on the principles of compliance with the help of two tools – assessment of the quality of the transfer pricing policy and internal control system (as a result of interaction of internal and external control systems) and assessment of the quality and effectiveness of the internal audit system of transfer pricing (as a result of interaction of internal control and audit systems). In accordance with the above, tax compliance control and audit becomes a new element of the established system of monitoring of controlled transactions of a business entity, which proposed to understand as the use of tools to confirm the quality and effectiveness of internal control and audit systems of transfer pricing transactions of a business entity by the tax authority, which confirms the taxpayer's commitment and responsibility to comply with tax legislation in terms of compliance with the arm's length principle.

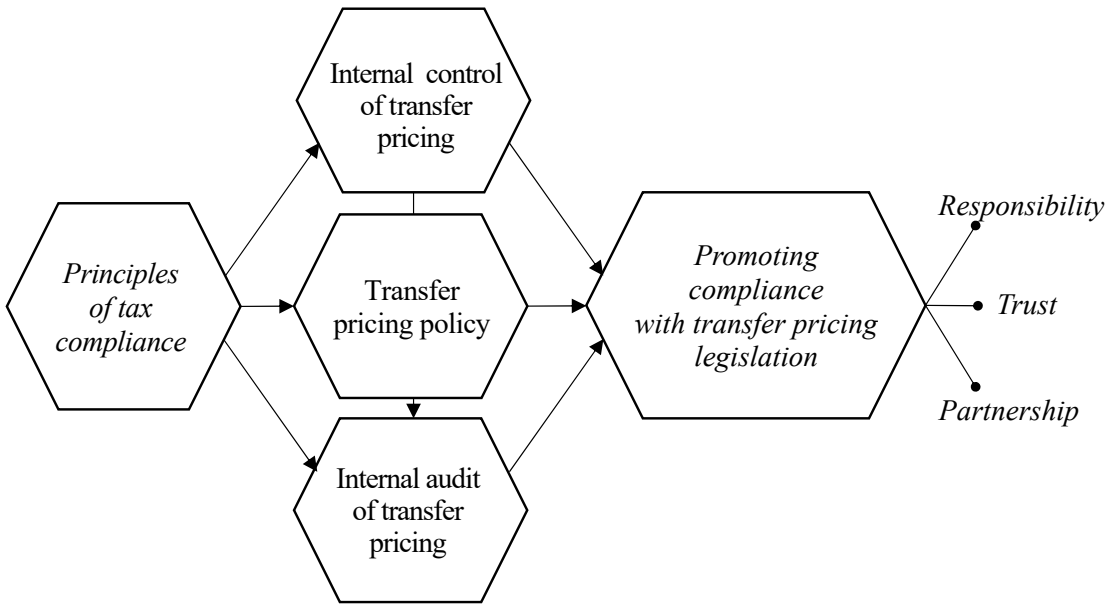


Figure 4 Model of tax control and audit of transfer pricing transactions based on tax compliance

Source: compiled by the authors

Confirmation by the tax authorities of the quality of the transfer pricing policy and internal control and audit system of the entity should be based on the developed, tested and approved system of assessment parameters. Confirmation of the assessment of the quality of the transfer pricing policy and internal control system will demonstrate the responsible position of the taxpayer based on tax compliance with the transfer pricing legislation in accordance with the arm's length principle and will increase the level of trust in it on the part of the tax authorities. In turn, the introduction of such a tool as an internal transfer pricing audit quality assessment into the process of monitoring-controlled transactions will allow the company to submit and use the results of its internal audit in assessing transfer pricing risks to form its tax rating and assess the need to include it in the audit plan. This tool assumes that the internal audit system is sufficient to timely detect violations of tax legislation in the field of transfer pricing in accordance with the arm's length principle.

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