

Mitigating Transfer Pricing Risk Through a Global PEO

How a global PEO alleviates
the challenges associated with
transfer pricing compliance.

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Mitigating the Unique Challenges of Transfer Pricing Compliance

Technological advancements have not only fueled global economic growth but also have essentially blurred the boundaries and associated restrictions between countries around the world. Today, conducting business globally is no longer exclusively limited to multinational corporations. Small and medium-sized Enterprises (SMEs) with limited resources are increasingly expanding to international territories. However, unlike multinational companies, SMEs lack the infrastructure and capital to operate in foreign countries whilst ensuring legal compliance. Thus, SMEs can transfer administrative tasks associated with HR and tax compliance to Professional Employer Organizations (PEOs). PEOs act as an Employer of Record and are ultimately responsible for ensuring compliance and paying taxes of their clients. However, cross border businesses are often subjected to corporate tax risks, whereby transfer pricing risk poses the most significant threat. Global PEOs can help their clients deal with the challenges associated with transfer pricing compliance and so much more.

* Methodology

Extensive research was conducted to prepare this report. Government publications, international publications (e.g. Organization for Economic Co-operation and Development (OECD documents), Big 4 accounting firms (PWC, Deloitte, and EY), and peer reviewed Journal articles were mainly used to write this report. The findings were further complemented by various websites and articles.

Global PEO

Global PEOs are gaining traction around the world due to the innumerable benefits they provide to small- and medium-sized enterprises. The PEO market share was approximately 48.6 billion USD in 2019 and is projected to rise to nearly 140 billion USD in 2029 (Straits Research, 2020).

The rise of global PEOs is primarily fueled by the exponential growth of SMEs, especially those seeking to expand or initiate business operations in foreign countries. PEOs are firms configured in a specialized manner, offering an array of HR services to their mostly SME clientele. These services include handling employee payroll, benefits (via mutually agreed benefit plans with insurance firms), employees' compensation and human resource compliance (Heller, 2020).

Moreover, PEOs usually operate as well known and officially recognized legal entities with business IDs and payroll registration in different parts of the world. They also operate as an 'Employer of Record' (EOR), whereby the PEO acts as the official employer for tax purposes. This essentially allows PEOs to eliminate any common tax and legal obstacles, helping them facilitate SMEs in foreign jurisdictions. To reap the benefits of Global PEOs, clients must sign a co-employment contract with a PEO, thereby making the PEO the official Employer of Record in the designated country (Heller, 2020).

Certain nations require PEOs to be legally certified and officially recognized. For instance, US law requires PEOs to be endorsed by 'employer services assurance corporation' (ESAC) to prove that they are compliant with industry guidelines (Heller, 2020). International PEOs must contact the pertinent country's employment regulators to make sure that they are not in breach of any domestic laws.

These agreements have proven to be extremely beneficial for companies with limited resources. In exchange for a small fee, PEOs not only handle all administrative tasks associated with HR operations in a foreign territory but also ensure that these companies aren't breaking any local or international laws. This allows companies to focus on their primary product or service instead of wasting resources on administrative tasks.

Findings indicate that SMEs that enlist the services of a PEO grow 7% to 9% faster than those operating independently (Napeo, 2021). Companies working with a PEO also have 10% to 14% lower than average employee turnover (Napeo, 2021). Global PEOs are cost effective as well — companies using the services of a PEO save around 27% on expenses pertaining to HR and compliance in foreign territories (Napeo, 2021).



Demystifying Transfer Pricing

Transfer pricing is an accounting technique applicable to charging different divisions or segments of a company for goods and services sold (Tax Justice Network, 2021). This principle is usually used when different divisions act as separate profit centers (Bragg, 2021). Transfer pricing is founded on the arm's length principle, a strong basis for determining prices of goods and services exchanged between controlled parties. According to the arm's length principle, entities that are associated through management, control or investment in their controlled transactions should abide by similar terms and conditions that would have been mutually decided between unrelated entities for similar uncontrolled transactions (Transfer Pricing Asia, 2021).

Multinationals operating at a large scale often have complex transactions due to their size, making it rather difficult to use the arm's length principle in a manner that complies with tax regulations. Tax authorities around the globe are also increasingly concerned about the possibility of multinational companies using transfer pricing and specifically the arm's length principle to avoid and evade tax by shifting profits to tax havens (Tax Justice Network, 2021).

Curbing Tax Avoidance & Evasion

Tax avoidance and tax evasion is an extremely important issue that is taking center stage at all political and governmental levels. This was partly driven by the infamous leaks of Panama Papers and Paradise Paper, which revealed the extent of tax evasion by corporations and high net worth individuals by using offshore accounts.

Now, tax authorities and regulators are implementing concrete measures to curb tax evasion, helping to increase the scrutiny and due diligence by tax authorities with regards to transfer pricing. Findings suggest that around 57% of tax administrators and 48% of corporations consider transfer pricing to be the most significant tax compliance risk (Borkowski and Gaffney, 2014).

Business leaders around the world are faced with serious challenges stemming from the risk of non-compliance with transfer pricing regulations. These include violating transfer pricing rules and double taxation by companies (Kane, 2019). On the other hand, tax regulators are concerned with transfer pricing as they seek to reduce profit shifting, revenue losses and ultimately counteract any form of tax evasion (Kane, 2019).



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Key Ways to Mitigate Transfer Pricing Risk Through a Global PEO

Transfer Pricing Risk

Transfer pricing has become a key cornerstone of tax planning and regulation. It requires specialized knowledge and expertise about different countries and tax jurisdictions (Rogers and Oats, 2019). Thus, it can be argued that transfer pricing specialists must not only be local professionals but also have the ability to occupy transnational spaces (Spence et al., 2015). These specialists are experienced as they undertake practical measures to ensure that businesses are being compliant with the arm's length principle with regards to allocating profits between different jurisdictions.

In most tax jurisdictions around the world, transfer pricing must meet the criteria of an 'arm's length' transaction, meaning the price charged for an intercompany transaction must be equivalent to a similar transaction between two unrelated parties. Tax authorities are concerned about businesses paying less taxes in the jurisdiction where they are operating or creating value by evading the 'arm's length' principle of transfer pricing and overcharging intercompany transactions to increase costs and reduce taxable profit (Moore, 2020).

Therefore, transfer pricing is a fundamental global issue that affects jurisdictions and their ability to collect taxes around the globe. The risk with transfer pricing is that companies will use it for tax evasion. This usually leads to hefty fines and disciplinary action by government agencies and can also lead to the business being banned from operating in a certain country (Moore, 2020). There is an additional risk that companies may inadvertently pay tax

twice due to the complexities of transfer pricing rules and regulations. Businesses usually don't possess the expertise and relevant strategies to deal with transfer pricing risk.

Companies operating in more than one territory often struggle with determining their taxable profit and reach an agreement with various tax administration regarding the appropriate share of taxable income in their respective jurisdiction (Rogers and Oats, 2019). Companies are increasingly using Global PEOs to efficiently manage their corporate risk, ranging from permanent establishment risk, transfer pricing risk to payroll compliance (PWC, 2018).

Mitigation

Global PEOs or the 'Employer of Record' are ultimately responsible for calculating and paying taxes of their clients in addition to ensuring compliance with local laws and regulations. That's why PEOs conduct due diligence, keep up to date with the tax laws in a particular jurisdiction and keep up to date with any changes in the local laws (Moore, 2020). Global PEOs can play an instrumental role in mitigating transfer pricing risk in the following ways.

Global PEOs Maintain Extensive Documentation

Global PEOs can mitigate transfer pricing risk by expanding their documentation efforts (Griffin, 2020). All transfer pricing documents should be available, accurate and up to date. Companies conducting business in foreign jurisdiction understand well conceptualized and consistent transfer pricing structure is crucial to lower transfer pricing tax risk.

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Taxation and regulations, especially on the OECD platform, are rapidly evolving. Thus, businesses, especially those with multifaceted or digital business models with a lot of intellectual property, should evaluate and assess draft reports and documents as soon as they become available. Global PEOs must maintain documents pertaining to intercompany transactions (i.e. those transactions between the PEO and their clients). Additionally, they must maintain all documents related to transfer pricing and their client's taxable profit. This allows them to comprehend and predict tax changes beforehand and then make contingency plans to deal with the changing tax regulations.

PEOs play a crucial role in facilitating ongoing monitoring and assessment of local tax laws and regulations.

The most important way to mitigate transfer pricing risk is having proper and periodically updated documentation as this allows a PEO to be well equipped and prepared if tax authorities decide to conduct an audit. This extensive documentation usually acts as an initial roadmap for tax authorities that are seeking corroboration for deductions and evidence proving compliance with transfer pricing requirements (PWC, 2018).

Global PEOs Ensure Intercompany Service Agreements

Global PEOs can further mitigate transfer pricing risk by ensuring intercompany service agreements (Moore, 2020). Global PEOs facilitate their clients with functions such as HR, payroll management and compliance with tax laws. In order to ensure transparency and

legality, PEOs must sign a co-employment agreement with their clients. This will allow them to ensure that all financial transactions between the two parties are well documented and on record. Tax regulators and authorities usually ask for the intercompany agreements whilst reviewing compliance with transfer pricing. Tax authorities and regulators will particularly be concerned with intercompany service agreements for employees that frequently work in more than one jurisdiction. This is because the tax authorities are seeking to ensure that their arrangements abide by the arm's length principle and that the contractual agreement corresponds with the value of services completed.

Furthermore, highly skilled employees with specialized knowledge and expertise who frequently travel between countries are considered to be transferring intellectual property (PWC, 2018). Thus, tax directors should assess whether their intercompany pricing of services between different parts of a company or related parties captures such value. Global PEOs can facilitate tax directors as they are responsible for managing the employees.

Global PEOs Address Challenges Associated with Disparity Between Transfer Pricing Laws

There can be disparity between local and international rules regarding transfer pricing. The Organization for Economic Co-operation and Development (OECD) offers rules and regulations regarding transfer pricing via their Base Erosion and Profit Shifting (BEPS) initiative. In 2019, they added country profiles on transfer pricing for Chile, Finland, and Italy containing information on OECD transfer pricing rules and the local transfer pricing

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guidelines, respectively. OECD possesses transfer pricing country profiles of 55 countries (OECD, 2021). This can be used by Global PEOs to help with transfer pricing compliance. Currently, OECD has 38 countries that are active members (OECD, 2021). Consequently, these countries abide by the arm's length principle laid out by the OECD. These include countries such as United States, United Kingdom, Turkey, Japan, Canada, and Australia. However, most of the countries around the world are not members of the OECD.

Hence, these countries have their own domestic transfer pricing laws that may differ from those proposed by OECD. Global PEOs can play an instrumental role in such circumstances where countries are not following international guidelines on transfer pricing. Global PEOs will usually be based in the local country, and thus will be familiar with the domestic laws and regulations. This would give them an edge over those working remotely from the head office of a company.

PEOs are usually based in countries where their clients are subject to tax, even though the head offices of their clients are located elsewhere. Companies need to ensure that their intercompany transactions are not breaching the local laws related to transfer pricing or the arm's length principle. PEOs have a locational advantage over their clients as they are well versed with the local laws of the jurisdiction where the company is paying taxes and understand the business environment in general. They can conduct and stay on top of local transfer pricing laws and regulations much faster than if their clients were operating independently from their respective countries. In certain cases, they are also aware of proposed changes even before they have been approved, helping them predict and prepare for any changes in the transfer pricing laws in order to address changing circumstances.

Global PEOs Allow Their Clients to Take a More Holistic Approach to Transfer Pricing

Around 40% of company executives argue that challenges to transfer pricing (TP) over the past 3 years have led to double taxation (Griffin, 2020). This shows that transfer pricing risk is extremely high and companies, especially those with limited resources and capital, need help to not only ensure compliance but also avoid double taxation due to miscalculation and erroneously paying taxes in both where the SMEs head office is and where the PEO or Employer of Record is located.

Companies are unable to ensure compliance with transfer pricing regulations in all the countries that they operate in (Griffin, 2020). That's why they usually focus only on the high tax risk jurisdictions. However, scrutiny over taxation and transfer pricing in particular is increasing. Thus, in order to mitigate transfer pricing risk, it is important to ensure a more holistic approach and involve all countries. This can be done by using PEOs. Global PEOs have teams that can help their clients ensure compliance in most of the jurisdictions that they operate in.

Global PEOs Interconnect Corporate Tax & HR in a Seamless Manner

The BEPS (Base erosion and profit shifting) initiative by the OECD entails high level of due diligence with regards to maintenance of proper documentation and the employment structure facilitating employment activities that takes place in more than one nation (PWC, 2018). Businesses must ensure that they have internal controls that enable them to track and report mobile employees and understand

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the exact type of work-related responsibilities that they are undertaking. Companies will need cooperation and coordination with their corporate tax departments to maintain suitable transfer pricing policies. They must also make sure that recharges correspond with transfer pricing regulations so they can truthfully capture the actual work performed and the value created in each legal jurisdiction.

Additionally, corporate tax must corroborate and communicate with the HR and global mobility departments whilst discussing and strategizing foreign operations and international tax planning. Thus, it is imperative that tax and HR departments are in correspondence and communication with one another and form a holistic approach as there can be some differences between personal and corporate tax purposes. Global PEOs play an instrumental role in mitigating transfer pricing risk as they interconnect corporate tax and HR functions in a seamless manner.

PEOs are essentially the Employer of Record and thus are responsible for managing HR functions. Additionally, they are also responsible for compliance with corporate taxes, helping them connect mobile workforce, HR functions, and corporate taxation in a seamless manner.



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The Role of a Global PEO

This paper demonstrates the ways companies can mitigate transfer pricing risk by using Global PEOs. Transfer pricing risk mainly stems from mispricing intercompany service agreements or transactions between related parties. There is a risk that companies may pay more tax than they are liable to pay due to a lack of understanding of the transfer pricing laws.

Additionally, governments are also increasingly concerned with transfer pricing as they believe that companies can use loopholes in the transfer pricing laws to transfer their profits to tax havens and evade paying taxes. Global PEOs can help mitigate transfer pricing risks in five key ways. Global PEOs can mitigate transfer pricing risk by maintaining extensive documentation, ensuring intercompany service agreements, addressing challenges associated with disparity between transfer pricing laws, allowing their clients to take a more holistic approach to transfer pricing, and interconnecting corporate tax and HR functions in a seamless manner.

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