

Agenda Item 8

[Working Draft – Framework Document]

Chapter 10

Transfer Pricing Audits and Risk Assessment

[This paper is based on a paper prepared by Members of the UN Tax Committee's Subcommittee on Practical Transfer Pricing Issues, but includes Secretariat drafting and suggestions not yet considered by them – the Secretariat takes responsibility for any relevant errors and omissions.]

Table of Contents

1.	Introduction	6
2.	Organization and Staffing of Transfer Pricing Audits.....	7
3.	Selection of Taxpayers for Transfer Pricing Examination – Risk Assessment	7
3.1.	Types of approaches.....	8
3.1.1.	Transactional approach	8
3.1.2.	Jurisdictional approach.....	8
3.1.3.	Risk based approach.....	9

3.2.	Sources of information for risk assessment	9
3.2.1.	Tax returns.....	10
3.2.2.	Publicly available data	10
3.2.3.	Court case judgements	11
3.2.4.	Financial statements.....	11
3.3.	Risk Factors/Risk Flags	11
3.4.	The Risk Assessment Process	12
3.5.	Risk Assessment Tools	13
3.6.	Risk Assessment Findings	14
4.	Planning for Transfer Pricing Examination.....	14
4.1.	Formation of Examination Team	14
4.2.	Supervision of Examination	14
4.3.	Issues for Examination.....	14
4.4.	Audit Timetable	15
4.5.	Information Already in Hand	15
4.6.	Information to be Collected	15
4.7.	Statute of Limitations as provided for in the domestic laws.....	15
4.8.	Approvals and Sign-off	15
5.	Preliminary Examination and Decision to Continue or Discontinue Transfer Pricing Examination	15

5.1.	Desk Audit.....	15
5.2.	Analyses	15
5.3.	Understanding the taxpayers' business	15
5.4.	Understanding the industry the taxpayer is in.....	15
5.5.	Approval	15
6.	Examination Procedure.....	15
6.1.	Audit approach	16
6.2.	Gathering of Information	16
6.2.1.	How?.....	16
6.2.2.	From Whom?.....	16
6.2.3.	Language.....	16
6.3.	Type of Information to be gathered.....	16
6.3.1.	General Information	16
6.3.2.	Financial Information	16
6.3.3.	Third Party Information	16
6.3.4.	Approval	16
6.4.	Contemporaneous Documentation.....	16
6.5.	Information Request List	16
6.6.	Initial Information Requests	16
6.7.	Supplemental Information Requests.....	17

6.8.	Requests for Interviews.....	17
6.9.	Taxpayer’s Responses to Requests for Information and interviews	17
6.10.	Requests or Summons for the production of books, records or other written information.....	17
6.11.	Information Held by Foreign Related Parties	17
6.12.	Secret Comparables.....	17
6.13.	Unrelated Third Party Information.....	17
6.14.	Information Exchange under Tax Treaties	17
6.15.	Attorney-Client Privilege and Work Product Doctrine	17
7.	Narrowing of issues – Development of Tax Authorities’ Position	17
7.1.	Refining understanding of taxpayer’s business.....	17
7.2.	Refining understanding of taxpayer’s industry	17
7.3.	Refining Functional and Risk Analysis.....	17
7.4.	Choice of Transfer Pricing Method.....	17
7.5.	Interaction with Taxpayer and Advisors.....	17
7.6.	Draft proposed adjustments (examiner’s interim opinion)	17
7.7.	Formal notification to taxpayer of proposed adjustment.....	17
7.8.	Issuance of adjustments.....	17
7.9.	Settlement opportunities	18
8.	Case Closure.....	18

8.1.	Audit Report	18
8.2.	Supervisor Approval	18
8.3.	Issuance of Assessment or Transfer Pricing Adjustments	18
8.4.	Administrative appeals	18
8.5.	Settlement procedure	18
9.	Relationship between Transfer Pricing Audits and APAs.....	18

1. Introduction

(To be expanded and finalised)

The establishment of an appropriate “arm’s length” result is not an exact science and requires judgment, based on sound knowledge, experience and skill on the part of the taxpayer and the revenue authority alike.

As a result of the complexities inherent in transfer pricing, a transfer pricing enquiry is usually complex and can therefore become a costly exercise both for a revenue authority and the taxpayer. It should therefore not be undertaken lightly and without giving due consideration the possible complexities or a fully considered assessment of the amount of tax that is likely to be at risk.

The outcome of an effective audit process is two-fold: (i) increased future compliance (which indirectly contributes to future tax revenue and protection of the tax base) and (ii) increased current tax revenues (where cases are successfully audited). It should be stated at the outset that transfer pricing audits generally take a long time to finalise and the increase of “current” tax revenues in the context of transfer pricing may refer to revenues that would be collected in a year or two. Whilst the hard work involved in a transfer pricing audit may therefore result in significant revenue adjustments that can be used for development of the country, such results definitely do not come quickly and easily – considerable resilience is required due to the complexity and uncertainty inherent in transfer pricing issues. Transfer pricing units (both in the revenue audit environment and corporate consulting) often come under significant scrutiny due to the fact that transfer pricing resources are expensive, yet the returns don’t come immediately or often.

Auditors might be tempted to go beyond the need for the TP audit if there is no programme to guide the audit. Hence a standard audit procedure must be in place to guide the conduct of the audit

2. Organization and Staffing of Transfer Pricing Audits

(To be expanded)

- *Centralised versus decentralised approach*
- *Type of examples of structures*
- *Examples from developing countries in particular*

3. Selection of Taxpayers for Transfer Pricing Examination – Risk Assessment

Profits could be suppressed or undervalued as a result of intentional manipulation of transfer prices or due to a taxpayer paying insufficient attention to the pricing of inter-company transactions. In practice, it is generally more likely that the cases where significant amounts of tax are at stake are those that result from manipulation of prices by businesses rather than an oversight on the part of the taxpayer. Accordingly, it is important to establish at the outset of a **risk assessment**, what the extent of the opportunity for manipulation by the taxpayer to obtain a tax advantage is.

There are various factors that could be used to “flag” higher risk transactions and these will be discussed in more detail below.

The higher the “quality” of the cases referred for audit, the higher the probability of successful audits. It is therefore just as important to dedicate adequate time and resources to risk assessment as it is to dedicate the appropriate time and resources to the audit of a case.

Materiality, used in isolation, generally isn’t a reliable basis for risk assessment, as transactions are usually over or under valued due to transfer pricing.

Accordingly, where materiality is used as the primary basis for case selection, a transaction may be overlooked due to it appearing immaterial. This could be, directly, as a result of the entities charging non-arm's length prices.

It is advisable to separate the risk assessment process for transfer pricing and thin capitalisation purposes (depending on the legislation in your country). Thin capitalisation is generally easier to detect (particularly where a debt to equity safe harbour is in place as is the case in most countries) and the auditing process may be shorter. On the other hand, transfer pricing audits generally take much longer to resolve and are usually much more complex.

Consistency vs. flexibility (transfer pricing isn't an exact science) – in one case varying margins will be an indication of a risk (for instance where the entity is a limited risk distributor) whereas constant margins in another case could be indicative of transfer pricing risks.

3.1. Types of approaches

There are various approaches that one could take in order to identify companies/groups with transfer pricing risks. These include:

- a) The transactional approach
- b) The jurisdictional approach
- c) The Risk Based approach

3.1.1. Transactional approach

Starting with simpler transactions that may be easier to price e.g. provision of services, interest-free loans, etc.

Alternatively, one could attack those transactions where the risk is deemed to be the highest e.g. transactions involving the use or transfer of intangible property.

3.1.2. Jurisdictional approach

Auditing those transactions entered into with entities in low or no tax jurisdictions. This can be controversial, but targeting transactions with such jurisdictions for audit is relatively common. In some countries (such as Brazil) transactions with specified such jurisdictions are automatically treated as “related party transactions” subject to transfer pricing scrutiny

3.1.3. Risk based approach

This is in essence a hybrid of the first two approaches, but would also consider factors other than the jurisdiction of the related party/ies and the type of transactions. Other factors of interest would for instance include:

- The tax compliance status of the local entity or the multi-national group to which the entity belongs (i.e. how compliant is the company/group generally or specifically to transfer pricing in your country or elsewhere in the world). Groups/entities successfully investigated by other revenue authorities could provide an indication that the group is of a higher risk for transfer pricing purposes.
- A group that has recently undergone a business restructuring particularly where the local entity has been “stripped” of certain risks and/or functions as part of the restructuring.
- Companies with excessive and/or continued accounting/tax losses relative to a profitable group outside your country.

3.2. Sources of information for risk assessment

3.2.1. Tax returns

- Work as far as possible with the information provided by the taxpayer. The tax return should ultimately aim to obligate taxpayers to include that information which would be most useful for the tax authority to utilise for effective risk assessment. The use of quantitative rather than qualitative data will assist in the automation of risk assessment tools. Examples of useful information on transactions include the value of any cross-border related party:
 - Sales;
 - Purchases;
 - loans, including interest received and/or accrued;
 - royalty payments;
 - service fees;
 - derivatives transactions;
 - debt factoring or securitisation transactions; or
 - share remuneration transactions.

3.2.2. Publicly available data

e.g. newspapers, websites, databases and publications such as “Who owns Whom”, Amadeus company database. Unfortunately databases and publications in this area can be expensive, however, and developing countries may often have to be more reliant on information provided by taxpayers than their colleagues’ in developed countries.

3.2.3. Court case judgements

Published judgements of cases heard in other countries may contain useful intelligence regarding a group's activities, transactions and pricing policies. These could also provide useful guidance on structures/schemes implemented in certain industries e.g. the UK Dixon's case as relates to the (ab)use of captive insurance arrangements in the retail industry. The analysis of such decisions provided by law and accountancy firms to their clients, such as on the Dixon's Case is often freely available and can also be helpful in identifying similar issues in your jurisdiction¹. Access to transfer pricing information databases such as of BNA or the IBFD can also be useful, if the cost of at least one licence can be organised through the administration budget or donor support.

3.2.4. Financial statements

Particular attention should be paid to notes to the financial statements on related party transactions, loans/financial assistance.

3.3. Risk Factors/Risk Flags

Certain "flags" can point to the need for further examination. They should not be treated as decisive that mis-pricing has occurred, of course – at most they point to a higher than normal likelihood of such mis-pricing. They include:

- Consistent and continued losses;
- Transactions with related parties in countries with lower effective/marginal tax rates, especially secrecy jurisdictions;

¹ See, for example <http://www.ffw.com/pdf/DSG-Retail-v-HMRC.pdf>

- Local low profit or loss making companies with material cross-border transactions with related parties offshore and the offshore part of the group is relatively much more profitable.
- The existence of centralised supply chain companies in favourable tax jurisdictions i.e. centralised sourcing or marketing companies located in jurisdictions with low or no tax regimes and which are not located in the same country/region as the group's main customers and/or suppliers.
- Material commercial relationships with related parties in jurisdictions with aggressive/strict transfer pricing rules – the corporate group may be more likely to transfer price in favour of the more aggressive jurisdiction and at the cost of the less aggressive jurisdiction, due to the higher likelihood of intense scrutiny in the first jurisdiction.
- The same applies in the case of material commercial relationships with companies located in the “home” jurisdiction of the MNE or where the holding company is listed.
- Similarly, material commercial relationships with companies in jurisdictions that employ safe harbours/rules that do not always align to the arm's length principle.

3.4. The Risk Assessment Process

[To be expanded]

The basic steps of the risk assessment process can be described as follows

- Initial review and identification of the possible risks
- High-level quantification of the possible risks
- Gathering of other intelligence
- Decision as to whether to proceed

- More in-depth risk review including high-level review of documentation and functional analysis to confirm initial findings
- More detailed quantification of possible risks
- Initial interactions with taxpayer
- Decision as to whether to proceed to audit by way of specialist reviews or committee based/panel reviews

3.5. Risk Assessment Tools

You should design basic tools around quantitative information readily available to non-transfer pricing auditors e.g. information available from the tax returns and audited financial statements to assist auditors in flagging those cases with probably transfer pricing/thin capitalisation risks to the transfer pricing unit.

These basic tools should ideally not require the auditors to apply their discretion or have any transfer pricing/thin capitalisation knowledge but should merely require them to input certain data, run the calculations (if not automated) and report the results (where above or below certain pre-established thresholds) to the transfer pricing unit. The decision as to whether to involve the auditor going forward is then a decision that should be made on a case-by-case basis by those with special transfer pricing expertise as part of the audit process (assuming the case proceeds to audit).

[Example to be provided]

Basic quantitative risk assessment tools are particularly effective in the identification of thin capitalisation risks as this usually involves a quantitative test of the financial data and is, in most cases depending on the local legislation, a matter of fact rather than opinion. Automated risk assessment tools that can be used to run through large sets of data already available can be used very effectively in this area.

[Example to be provided]

More sophisticated risk assessment tools could be developed to serve as guidelines to more inexperienced transfer pricing specialist auditors. Examples include tools to “rate” the quality of a company’s transfer pricing documentation, etc. These tools are usually based on the principle of trying to assign a value to qualitative factors in an attempt to be able to distinguish/rank different transfer pricing cases or risks.

For example, a tool could provide a list of factors that need to be considered in evaluating the quality of a company’s transfer pricing documentation, providing a ranking from 1 – 5 for each factor. Based on the final total score, the documentation is assigned a “risk rating”. These tools are most effective when used by auditors with some transfer pricing knowledge/training/experience, as they do require the auditor to apply discretion or form a qualitative opinion on the matter.

[Example to be provided]

3.6. Risk Assessment Findings

- Database of cases assessed whether or not proceeding (including filing all workings)
- Document reasons for decision

4. Planning for Transfer Pricing Examination

[To be expanded]

4.1. Formation of Examination Team

4.2. Supervision of Examination

4.3. Issues for Examination

4.4. Audit Timetable

4.5. Information Already in Hand

4.6. Information to be Collected

4.7. Statute of Limitations as provided for in the domestic laws

4.8. Approvals and Sign-off

Approval of superior officer/committee is required on the case preparation

5. Preliminary Examination and Decision to Continue or Discontinue Transfer

Pricing Examination

[To be expanded]

5.1. Desk Audit

A quick check on the returns submitted by the taxpayer with a view to determining the TP issues in the return

5.2. Analyses

Carry out analysis of the findings from desk audit to determine the nature of further audit to be done.

5.3. Understanding the taxpayers' business

5.4. Understanding the industry the taxpayer is in.

5.5. Approval

Approval of superiors will be required before embarking on full audit of the company for TP

6. Examination Procedure

[To be expanded]

6.1. Audit approach

- Limit the duration of the audit as far as possible without compromising quality.
- Don't take on too many cases at once.
- Mixture of complex, large cases and smaller simpler cases (including to make best uses of auditors, to give them variety and experience).
- Timing – don't focus on cases that are very old unless validated by the size, abusive nature etc.
- Quality of information gathering will directly affect the quality of the case and the possible outcome. Keep an eye on the evidential aspect – treat every case as though you will have to prove it in court.

6.2. Gathering of Information

6.2.1. How

6.2.2. From Whom

6.2.3. Language

6.3. Type of Information to be gathered

6.3.1. General Information

6.3.2. Financial Information

6.3.3. Third Party Information

6.3.4. Approval

6.4. Contemporaneous Documentation

6.5. Information Request List

6.6. Initial Information Requests

- 6.7. Supplemental Information Requests**
- 6.8. Requests for Interviews**
- 6.9. Taxpayer's Responses to Requests for Information and interviews**
- 6.10. Requests or Summons for the production of books, records or other written information**
- 6.11. Information Held by Foreign Related Parties**
- 6.12. Secret Comparables**
- 6.13. Unrelated Third Party Information**
- 6.14. Information Exchange under Tax Treaties**
 - [6.14.1 The nature of the obligation**
 - 6.14.2 Practical issues]**
- 6.15. Attorney-Client Privilege and Work Product Doctrine**
- 7. Narrowing of issues – Development of Tax Authorities' Position**
 - 7.1. Refining understanding of taxpayer's business**
 - 7.2. Refining understanding of taxpayer's industry**
 - 7.3. Refining Functional and Risk Analysis**
 - 7.4. Choice of Transfer Pricing Method**
 - 7.5. Interaction with Taxpayer and Advisors**
 - 7.6. Draft proposed adjustments (examiner's interim opinion)**
 - 7.7. Formal notification to taxpayer of proposed adjustment**
 - 7.8. Issuance of adjustments**

7.9. Settlement opportunities

8. Case Closure

8.1. Audit Report

8.2. Supervisor Approval

8.3. Issuance of Assessment or Transfer Pricing Adjustments

8.4. Administrative appeals

8.5. Settlement procedure

9. Relationship between Transfer Pricing Audits and APAs

[To be expanded]

- Once APA is agreed, examiners cannot audit a company – even during the APA negotiation.
- Any audits will happen in accordance with the agreed APA.

[10 The possibility of joint audits]