

AUDIT AND RISK ASSESSMENT

SUMMARY OF THE CHAPTER

As discussed in Chapter 1, establishment of an appropriate “arm’s length” result is not an exact science and requires judgment, based on sound knowledge, experience and skill. Owing to the complexities inherent in transfer pricing, a transfer pricing enquiry is usually complicated and can become a costly exercise both for a revenue authority and a taxpayer. It should therefore not be undertaken lightly; due consideration should be given to the possible complexities and to the amount of tax 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).**

The chapter has the following paragraphs

- **1. Organizations and Staffing of Transfer Pricing Audits:**
- Administrative Aspects
- Staffing and Resourcing

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

- Overview
- Categories of Risk

The following describes some of the more complex categories of risk that are not always readily identifiable. It is by no means exhaustive and it is acknowledged that additional classes and categories of risk may exist:

- 1. Intentional profit shifting through new structures;
- 2. Intentional profit shifting through restructuring;
- 3. Intentional profit shifting through incorrect functional classification, the use of incorrect methods, allocation keys, etc.
- 4. Thin capitalization; and
- 5. Unintentional profit shifting.

The risk classification provided here as an example assists the risk profiler/assessor in the evaluation of each of the following in respect of potential cases:

- The likelihood of detection by revenue authorities;
- The possible value of the profit shifting (and therefore the potential value of the risk); and
- The amount of time and resources required to audit the risk (including the level of expertise required from those resources)

Types of approach

- 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; and
- c. The risk based approach.

Risk factors/risk flags: Certain “flags” can point to the need for further examination.

- They should not be treated as decisive in determining that non arm’s length pricing has occurred, of course – at most they point to a higher than normal likelihood of such mis-pricing.
- See Chapter 4 for additional indicators of risk; commonly agreed risk indicators include:
- **6. The Risk Assessment Process**

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; and
- Decision as to whether to proceed to audit by way of specialist reviews or committee based/panel reviews.

Risk assessment findings

- It is important that the outcomes of a risk identification and assessment process be documented and signed off for governance and control purposes and preferably saved in a central repository (i.e. a database of cases assessed whether or not proceeding (including all workings)).

Planning for transfer pricing examination

- Formation of Examination Team
- Supervision of Examination
- Issues for Examination/Examination Plan
- Audit Timetable
- Information already in hand
- Information to be collected
- Statute of limitations as provided for in the domestic law
- Approvals and sign-off

Preliminary Examination

- Desk Audit
- Understanding the Taxpayers' Business
- Understanding the industry in which the taxpayer operates
- Approval

Audit procedure

- Audit approach
- Notification to taxpayer

Gathering of information

- Sources of information
- Language
- Types of information to be gathered
- Points for examination at the initial stage
- Contemporaneous documentation
- Information request list
- Supplemental information reports
- Request for interviews
- Request to visit facilities
- Attorney-client privilege and work product doctrine

Narrowing of issues – development of tax authorities' position

- Refining understanding of the taxpayer's business
- Refining understanding of the taxpayer's industry
- Refining functions and risk analysis

Choice of transfer pricing method

- After refining the functional and risk analysis, the examination team will choose the transfer pricing method in the light of that analysis. See Chapter 6 on selection of appropriate methods.
- Examiners' interim opinion or economist's report
- Draft proposed adjustments
- Formal notification to taxpayer of proposed adjustment
- Issuance of Adjustment/Correction
- Settlement opportunities

Case closure

- The case closure needs to be properly documented, as every decision taken can potentially be subject to litigation. The table below provides a clear documentation process to ensure the information needed is recorded and to guarantee that the required process has been followed.
- Relationship between transfer pricing audits and APAs
- As an example, the following measures are taken, in Japan: