
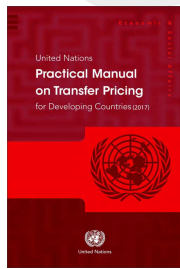

**UN-ATAF Workshop on Transfer Pricing  
Administrative Aspects and Recent Developments**  
 Ezulwini, Swaziland  
 4-8 December 2017


**AFRICAN TAX  
ADMINISTRATION FORUM**



**AUDIT AND  
RISK ASSESSMENT**  
 Monday, 4 December 2017  
 2.00pm – 5.00pm

**INTRODUCTION  
TO AUDITS AND RISK ASSESSMENT**

**Importance of Risk Assessment**

- TP audits are time and resource intensive (multi-disciplinary team) .
- The most appropriate cases should be selected for audit.
- Cost benefit analysis is key in any TP risk assessment
- Effective TP audit process (**Manual Section C.3.1**)
- ✓ Increased future compliance
- ✓ Increased current tax revenues

2

**SELECTION OF TAXPAYERS FOR TP EXAMINATION:  
RISK ASSESSMENT**

**Approaches to identify companies with TP Risks (Manual Section C.3.3):**

- **Transactional Approach:** Focus on specific transactions. (i.e. Interest free loans, Thin cap; Intra-group Services, Royalty payments; Business restructuring).
- **Jurisdictional Approach:** Focus on transactions (direct/indirect) with specific Tax Jurisdictions. Previous work on identifying high risk jurisdictions. Factors: Domestic tax rates; Domestic trade flows; Domestic economies policies
- **Risk based Approach:** Combination of previous approaches, but considering other factors such as:
  - ✓ Tax compliance status of the taxpayer or MNE.
  - ✓ If the Group has recently undergone a Business restructuring .
  - ✓ Recurring domestic tax losses.

3

**SELECTION OF TAXPAYERS FOR TP EXAMINATION:  
RISK ASSESSMENT**

**Risk Factors (Manual Section C.3.3.2)**

- Consistent and continued losses
- Local low profits or loss making companies with transactions with related parties, whereas the offshore part of the group is profitable.
- Financial results deviate from industry standards.
- Transaction with related parties in low tax jurisdictions (or “secrecy jurisdictions”),
- Intragroup service transactions or excessive royalties, management fees payments.
- The existence of centralized supply chain companies in favorable tax jurisdictions (i.e marketing or procurement companies located outside market countries or countries where manufacturing takes place).
- A high value of related party transactions compared to the taxpayer’s turnover and operating profits.

4

## SELECTION OF TAXPAYERS FOR TP EXAMINATION: RISK ASSESSMENT

### ➤ Risk Assessment Tools (Manual Section C.3.3.7)

High risk where financial result of the company under review deviate from industry standards or potential comparables. Common risk identification tools include templates for calculating key ratios relevant to TP.

### ➤ Key financial ratios relevant to TP

- ✓ Gross profit to net sales;
- ✓ Operating profit to net sales;
- ✓ Operating expenses to net sales;
- ✓ Gross profit to operating expenses (Berry ratio); and
- ✓ Operating profit to average total assets.

5

## SELECTION OF TAXPAYERS FOR TP EXAMINATION: RISK ASSESSMENT

### Sources of Information for Risk Assessment: (Manual Section C.3.3.4)

- **Tax Returns:** Information with related parties (i.e Sales; Purchases; Loans; Royalty payments; Service fees.
- **Public Information:**
  - ✓ Taxpayer's website; Press Reports; Trade magazines; Published Foreign TP cases.
  - ✓ Commercial databases (database search to verify if the company is within comparable's range)
  - ✓ Financial data to the security regulatory agency.
  - ✓ Customs data.
  - ✓ Exchange of information with other tax administrations.
  - ✓ Other sources of information may be available in the near future in an international context (i.e see for example the discussion on TP documentation and country by country reporting in the Action 13 Report of the OECD /G20 BEPS Project)

6

## SELECTION OF TAXPAYERS FOR TP EXAMINATION: RISK ASSESSMENT

### Basic Steps Risk Assessment Process (Manual Section C.3.3.6.2)

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

7

## PLANNING FOR A TP EXAMINATION

### ➤ Formation of the Examination Team (Manual Section C.3.4.1)

Overall Manager; Domestic examiner; International examiner; Transfer pricing Economist; Lawyer.

### ➤ Issues for examination/Examination Plan (Manual Section C.3.5)

- ✓ *Part one* identifies the audit team, the information they expect to obtain and the timetable for the examination.
- ✓ *Part two* identifies the tax administration's resources to be devoted to the examination, the accounts and transfer pricing issues under examination, the anticipated procedures for the examination of each issue, the personnel responsible for the various steps and the management procedures to be followed by the audit team.

8

## PRELIMINARY EXAMINATION

### ➤ Understanding the Taxpayer's business: (Manual Section C.3.5.2)

Essential part of the TP examination. This study can be commenced before or after starting a TP audit and should include:

- ✓ Taxpayer operations;
- ✓ Operations of its affiliates;
- ✓ Relationship between taxpayers and its affiliates;
- ✓ Role of each entity plays in carrying out activities of the controlled group;
- ✓ How much control or instructions receives from the HQ of the group.

9

## PRELIMINARY EXAMINATION

### Questions to understand taxpayer's operations

#### ➤ Distribution Activities (Manual Section C.3.5.2.4)

- ✓ Are affiliates manufacturing the same or similar products to those distributed by the taxpayer?
- ✓ Is technology transferred between affiliates and the taxpayer?
- ✓ Are trademarks and other marketing intangibles being used to market the product?
- ✓ Which members of the controlled group developed the trademarks and other marketing intangibles?
- ✓ Which members of the controlled group advertise?
- ✓ Which members of the controlled group created the sales tools?
- ✓ Which members of the controlled group created and maintained the list of customers?

10

## PRELIMINARY EXAMINATION

### Questions to understand taxpayer's operations:

#### Manufacturing activities (Manual Section C.3.5.2.5)

- ✓ Are affiliates distributing or selling the same or similar products to those the taxpayer manufactures?
- ✓ Is the taxpayer using the same or similar manufacturing intangibles to those its affiliates are using?
- ✓ What patents and/or know-how are involved in the relevant technology?
- ✓ Is there a cost sharing agreement?
- ✓ Did affiliates or the taxpayer buy into a cost sharing agreement?
- ✓ What research and development is conducted?
- ✓ What members of the controlled group do research and development?
- ✓ How are the results of research and development disseminated among members of the controlled group?

11

## PRELIMINARY EXAMINATION

### Understanding the following Intangibles (Manual Section C.3.5.2.6)

- Manufacturing and marketing intangibles;
- Domestic and foreign patents and any prosecutions involving the taxpayer;
- Licenses and assignments;
- Patent litigation involving the taxpayer;
- Domestic and foreign trademark registration and trademark litigation involving the taxpayer; and
- Copyright registrations at the patent or copyright office.

12

## PRELIMINARY EXAMINATION

### ➤ Procedure to understand the taxpayer's Industry: (Manual Section C.3.5.3)

- ✓ Identifying the industry association;
- ✓ Reviewing the industry association's publications and website;
- ✓ Reviewing industry guidelines used by the taxpayer;
- ✓ Consulting with various industry experts;
- ✓ Consulting various books and articles on the industry;
- ✓ Identifying competitors in the same industry;
- ✓ Comparing the competitors' activities with those of the taxpayer; and
- ✓ Comparing the competitors' financial data with those of the taxpayer.

13

## AUDIT PROCEDURE

### ➤ Notification to Taxpayer

### ➤ Request for Information:

- ✓ Corporate structure of the Group.
- ✓ Transfer Pricing documentation.
- ✓ Organization charts.
- ✓ Details on the business line of products of the taxpayer.
- ✓ List of main clients and suppliers (for purchase/sale operations).
- ✓ List of operations with foreign related parties
- ✓ Contracts with foreign related parties involving intra-group operations.
- ✓ Segmentation of the profits and loss statements on transactions under review

14

## AUDIT PROCEDURE

### ➤ Specific Request of information for type of operations:

- ✓ Loan Operations: Interest rate components; Interests accruals and capital amortization; credit rating of the borrower.
- ✓ Services: Type of service; Details on the fee determination method; cost drivers.
- ✓ Royalties: Rate and Method of determination; type of royalty and expenses associated to the royalty.
- ✓ Purchase of Fixed Assets: Commercial Valuation.
- ✓ Intangibles, Financial or other Assets: Assets Valuations (cash flow valuation or others)

15

## AUDIT PROCEDURE

### Points for examination at the Initial Stage:

- Whether the gross and operating profit margins arising from related transactions of the taxpayer are excessively low compared with those of internal or external comparables
- Use of the average value of the consideration or profit margins for related transactions or transactions deemed comparable with the related transactions during a reasonable length of time.

16

## AUDIT PROCEDURE

### ➤ Request for interviews:

- ✓ The examination team will choose the personnel to interview by requesting organization charts.
- ✓ The interviewees should be made familiar with the process and should understand the procedures, purpose and importance of the interview.

### ➤ Request to Visit Facilities

- ✓ Representatives of the examination team could be accompanied on the visit by an employee of the taxpayer who can describe the activities at particular locations and respond to questions.

17

## Narrowing of Issues: Development of Tax Authorities' Position

### ➤ Refining Understanding of the Taxpayer's Business:

- ✓ Reviewing information obtained earlier in light of the taxpayer's responses.

### ➤ Refining Understanding of the Taxpayer's Industry

- ✓ Reviewing product line financial statements for multiple years.

### ➤ Refining Functions and Risk Analysis

- ✓ Identify the most important functions in creating value in the taxpayer's related party operations.
- ✓ The effect of intangible property on the operations.
- ✓ Analyze economic conditions of the taxpayer's operations to later identifies comparable.

➤ (Manual Section C.3.6)

18

## Next Steps in the Audit Procedure

- Choice of Transfer Pricing Method
- Economist's Report or Examiners' Interim Opinion
- Draft Proposed Adjustments
- Formal Notification to Taxpayer of Proposed Adjustment
- Issuance of Adjustment/Correction

19

## CASE CLOSURE

The case closure needs to be properly documented, as every decision taken can potentially be subject to litigation.

20