PUBLIC CONSULTATION:
DRAFT HANDBOOK ON
TRANSFER PRICING RISK
ASSESSMENT
30 April 2013
April 2013

DRAFT HANDBOOK ON TRANSFER PRICING RISK ASSESSMENT

In November 2011, the Steering Committee of the OECD Global Forum on Transfer Pricing undertook a project on transfer pricing risk assessment. The objective of this project was to produce a practical handbook that provides clear and detailed steps countries can take to assess the transfer pricing risk presented by an individual taxpayer’s operations. The handbook is intended to be sufficiently detailed that it can serve as a manual for both developing and developed countries to use in conducting transfer pricing risk assessments.

The new Draft Handbook on Transfer Pricing Risk Assessment, produced by the Steering Committee of the OECD Global Forum on Transfer Pricing, is a detailed, practical resource that countries can follow in developing their own risk assessment approaches. This handbook supplements useful materials already available with respect to transfer pricing risk assessment. Individual country tax administrations have published information on their risk assessment practices. The OECD Forum on Tax Administration published a report entitled “Dealing Effectively with the Challenges of Transfer Pricing” in January 2012. One chapter of that report addresses transfer pricing risk assessment.

Interested parties are invited to provide comments on this Draft Handbook on Transfer Pricing Risk Assessment in Word format to TransferPricing@oecd.org by 13 September 2013. Unless otherwise indicated by the commentators at the time of submission, the comments received may be posted on the OECD website.
TABLE OF CONTENTS

1. INTRODUCTION TO TRANSFER PRICING RISK ASSESSMENT ................................................................. 4
   1.1 Objectives and rationale of this Handbook .......................................................................................... 4
   1.2 What is a transfer pricing risk assessment? ......................................................................................... 4
   1.3 Level of certainty required in assessing transfer pricing risk .............................................................. 6
   1.4 Level of detail and sophistication to be pursued ................................................................................ 6

2. QUESTIONS TO BE ANSWERED IN A TRANSFER PRICING RISK ASSESSMENT PROCESS .................. 8
   2.1 Are there material controlled transactions? ......................................................................................... 8
   2.2 Is there an indication of transfer pricing risk? ...................................................................................... 8
   2.3 Is the case worth an audit? ................................................................................................................... 9
   2.4 What specific issues need to be addressed during the audit? ............................................................. 10

3. ASSESSING WHEN TRANSFER PRICING RISK EXISTS AND WHEN IT DOES NOT .................. 11
   3.1 Risk factors ..................................................................................................................................... 11
       3.1.1 Risk arising from recurring transactions ...................................................................................... 11
       3.1.2 Risk arising from large or complex one time transactions ........................................................ 12
       3.1.3 Risk arising from taxpayer behaviour in governance, tax strategies or ability to deliver compliance ................................................................................................................................. 12
       3.1.4 Quantifying the amount of tax at risk .......................................................................................... 13
   3.2 Evaluating transfer pricing risk ........................................................................................................... 13
       3.2.1 Risk indicators observed from related party transactions .......................................................... 13
           3.2.1.1 Profitability ......................................................................................................................... 13
               3.2.1.1.1 In comparison to industry standards or potentially comparable companies ................ 13
               3.2.1.1.2 In comparison to related parties or group results .......................................................... 14
               3.2.1.1.3 Recurring losses, recurring low profits, or recurring low returns on investment .... 15
               3.2.1.1.4 Fluctuation contrary to market trends ........................................................................... 15
               3.2.1.1.5 Substantial or disproportionate income in low-tax jurisdictions .................................. 15
       3.2.1.2 Transactions with related parties in low-tax jurisdictions ......................................................... 16
       3.2.1.3 Intra-group service transactions ............................................................................................. 16
       3.2.1.4 Royalty, management fees, and insurance premium payments, particularly to entities in low tax jurisdictions .............................................................................................................. 16
       3.2.1.5 Marketing or procurement companies located outside market countries or countries where manufacturing takes place ........................................................................................................... 17
       3.2.1.6 Excessive debt and/or interest expense ...................................................................................... 17
       3.2.1.7 Transfer or use of intangibles to/for related parties .................................................................... 17
       3.2.1.8 Cost contribution arrangements ............................................................................................... 18
       3.2.1.9 Business restructurings ............................................................................................................. 18
       3.2.2 Non-tax factors that may distort pricing ....................................................................................... 19
       3.2.3 Quality of contemporaneous transfer pricing documentation ..................................................... 19
       3.2.4 Indications of low transfer pricing risk .......................................................................................... 20

4. SOURCES OF INFORMATION FOR CONDUCTING A TRANSFER PRICING RISK ASSESSMENT ................................................................. 22
   4.1 Specific tax return disclosures – information returns ........................................................................... 22
   4.2 Contemporaneous transfer pricing documentation ............................................................................... 23
   4.3 Questionnaires issued to selected taxpayers ....................................................................................... 24
   4.4 Taxpayer’s file and audit records of previous years ............................................................................ 24
4.5 Publicly available information regarding the taxpayer .................................................................24
4.5.1 Internet searches ..........................................................................................................................24
4.5.1.1 Taxpayers’ websites ...............................................................................................................24
4.5.1.2 Government agency databases ............................................................................................25
4.5.2 Commercial databases .............................................................................................................25
4.5.3 Press reports, trade magazines, etc ............................................................................................25
4.5.4 Securities analysts’ reports .........................................................................................................25
4.6 Site visits and meetings with company personnel ...........................................................................26
4.7 Customs data ................................................................................................................................26
4.8 Patent office ..................................................................................................................................26
4.9 Exchange of information under tax treaties .................................................................................27
4.10 Necessary legal provisions to facilitate access to information ......................................................27
4.10.1 Obtaining information relating to foreign associated enterprises ..............................................27
4.10.2 Obtaining information relating to domestic potentially comparable businesses .......................27
5. RISK ASSESSMENT PROCESS – SELECTING CASES FOR TRANSFER PRICING AUDIT ............30
5.1 Appropriate tax administration organisation for conducting risk assessments ............................30
5.2 Procedures and steps for conducting a risk assessment ..................................................................30
5.3 Preparing a risk assessment report ................................................................................................31
5.4 Use of specialists ............................................................................................................................31
6. BUILDING PRODUCTIVE RELATIONSHIPS WITH TAXPAYERS – THE ENHANCED ENGAGEMENT APPROACH ...........................................................................................................33
6.1 Objectives and rationale ..................................................................................................................33
6.2 Country examples ............................................................................................................................33
6.2.1 Netherlands ..................................................................................................................................33
6.2.2 United Kingdom ..........................................................................................................................34
6.2.3 United States ...............................................................................................................................35
6.2.3.1 CAP Background ..................................................................................................................35
6.2.3.2 How CAP Works ..................................................................................................................35
6.2.3.3 Outcomes Resulting from the CAP Process ........................................................................36
6.2.3.4 Pilot Made Permanent ..........................................................................................................36
ANNEX 1 INFORMATION RETURN FORMS ...................................................................................37
ANNEX 2 SUPPLEMENTARY QUESTIONNAIRES ............................................................................38
ANNEX 3 PROVISIONS TO REQUIRE INFORMATION HELD IN FOREIGN ASSOCIATED ENTERPRISES .................................................................................................................................39
ANNEX 4 PROVISIONS TO OBTAIN INFORMATION RELATING TO DOMESTIC POTENTIALLY COMPARABLE BUSINESSES ............................................................................................................40
HANDBOOK ON TRANSFER PRICING RISK ASSESSMENT

1. INTRODUCTION TO TRANSFER PRICING RISK ASSESSMENT

1.1 Objectives and rationale of this Handbook

1. Every tax administration operates with finite resources. While enforcement of transfer pricing rules is a key priority for most tax administrations, no country has the enforcement resources to perform a thorough audit of every possible transfer pricing case. As a result, decisions need to be made about how to most effectively deploy the available enforcement resources. Resource allocation ultimately requires an effective means to strategically select the cases that should be audited.

2. Effective risk identification and assessment are critical if tax administrations are to select the right transfer pricing cases for audit. Risk assessment before commencing an audit enables decisions about which cases should be audited, and when the risk is appropriately identified and assessed, enables the actual audit to be more focused, shorter and more effective.

3. In addition, it may waste taxpayer and tax administration resources to devote enforcement resources to cases where an adjustment could not ultimately be sustained in a mutual agreement procedure (“MAP”). Risk assessment can help avoid needless debates among tax administrations. For these reasons many countries have recently focused significant attention on the measures they use to identify and assess transfer pricing risk, and to select cases for audit.

4. This Handbook assembles recent country procedures, methods and practices in order to provide a resource to tax administrations designing their own risk assessment approaches. There is no single correct way to assess transfer pricing risk present in a particular case. Ultimately, each country will need to develop its own approach. However, this Handbook provides a practical resource that can be used by any tax administration seeking to develop or improve its risk assessment procedure, methods and practices.

1.2 What is a transfer pricing risk assessment?

5. A thorough transfer pricing audit can require the careful review of large amounts of information. In most cases it will require the full attention of a number of auditors, many meetings, the review of numerous documents and records, many of which may be located in foreign locations, site visits, the analysis of financial and economic data, research and review of information in data bases, a serious effort to understand the taxpayer’s business and how that business generates profit, and discussion and negotiation with the taxpayer. Such an audit will usually require the commitment of large amounts of time from a multi-disciplinary team of auditors possessing legal, accounting, economic and valuation expertise. In short, commencing a thorough transfer pricing audit is a serious commitment for a tax administration.

6. The decision to commit the resources necessary for a thorough transfer pricing audit should not be taken lightly, and should not be made without a plan for proceeding with the audit. It must be recognised that it is not necessary for a tax administration to conduct a thorough audit of every cross border transaction or related party relationship in order to achieve an effective level of transfer pricing enforcement.
7. Many taxpayers seek to comply with the applicable transfer pricing rules. They make conscientious efforts to establish prices for transactions that are consistent with the arm’s length principle. They prepare accurate intercompany agreements reflecting the manner in which they conduct their business and then they conduct the business in the manner described in those agreements. Such taxpayers prepare clear transfer pricing documentation that describes their material cross border transactions, describes in appropriate detail the functions, risks, and assets of various parties to those transactions, and shows how the most appropriate transfer pricing methods can be selected and applied to confirm the arm’s length nature of the prices charged with respect to the relevant transactions. The financial results of such taxpayers’ local country affiliates will likely reflect levels of profit that are generally consistent with comparable enterprises. Often such taxpayers will maintain open and transparent relations with the tax administration.

8. Where taxpayers are compliant, readily provide the tax administration with the relevant information, documents and analysis, engage principally in routine and readily understood commercial transactions, and make reasonable efforts to implement appropriate transfer pricing policies, they generally need not be subjected to a thorough transfer pricing audit every year.

9. However, not all taxpayers consistently exhibit this type of transparent compliance. Some taxpayers may seek to shift income into jurisdictions where it will be lightly taxed. They may not provide tax administrations with a full picture of their related party transactions. They may engage in transactions that are designed to erode, or have the effect of eroding, the local country tax base. They may not prepare documentation that accurately describes all material intercompany transactions and may not be fully transparent in applying appropriate transfer pricing methods to confirm the arm’s length nature of their related party pricing.

10. Even compliant taxpayers may at times engage in large or complex transactions where reasonable people could differ over whether their transfer prices are arm’s length, or where detailed investigation may be warranted to confirm transfer pricing compliance.

11. The challenge for tax administrations is to be able to distinguish taxpayers and transactions that involve a high degree of transfer pricing risk from those which do not, and to make such assessments accurately, with confidence, and with a limited expenditure of scarce resources. Drawing these necessary distinctions in an informed and methodical manner before commencing an actual audit is the role of a transfer pricing risk assessment.

12. A transfer pricing risk assessment can be a continuing exercise throughout an audit. The process of an audit from the filing of the tax return and the tax administration’s initial analysis of the taxpayer’s related party transactions to concluding that a transfer pricing adjustment should be made by investigating primary sources could be understood as a risk identification and assessment process. In this Handbook, however, the focus is on activities that should be performed before the decision is made to make a serious commitment of tax administration resources to seek and investigate primary sources. All activities described in this Handbook should be separately understood from those performed during an audit process after such a critical decision is made.

13. On this premise, when properly carried out, a transfer pricing risk assessment will:
   • Allow the tax administration to identify transfer pricing risk presented by a particular taxpayer;
   • Help the tax administration determine whether the level of the risk is high so that a detailed audit should be commenced;
• Enable the tax administration to develop a practical and coherent plan for auditing specific transactions that give rise to the transfer pricing risk;

• Allow the tax administration to assign the appropriate resources to any detailed audit activity that is necessary given the nature and amount of the risk; and,

• Help the tax administration frame the additional factual enquiries that will be undertaken during a detailed transfer pricing audit of the taxpayer’s specific related party transactions.

1.3 Level of certainty required in assessing transfer pricing risk

14. Transfer pricing risk assessment is the process of identifying the risk to the tax administration from the taxpayer’s transfer pricing arrangements and determining whether the risk is worth pursuit by conducting a resource-intensive audit. It requires a less intense investigation and fewer resources than would be required for a detailed audit. One consequence of this less intensive review is that the tax administration will always be in the position of needing to assess the risk without a complete understanding of the potentially relevant facts. Certainty in assessing transfer pricing risk will not be achieved and the risk assessment process will always be one of weighing and balancing the benefits of further factual investigation against the limitations on available resources for conducting such factual investigations.

15. As a result, the process of risk identification and assessment requires judgement and cannot be reduced to a set of mechanical rules. The fact that a case displays some of the features associated with high transfer pricing risk does not automatically mean that a thorough, detailed examination is necessary or worthwhile. For example, occasional losses are a genuine feature of business life and may not necessarily be the result of transfer pricing manipulation. Resources devoted to a risk assessment may not be sufficient to answer all of potential questions with complete certainty. They should, however, allow the tax administration to determine whether a detailed audit is warranted. Balance, judgment and experience will be hallmarks of a successful risk assessment process.

1.4 Level of detail and sophistication to be pursued

16. Although the risk assessment process cannot be reduced to a mechanical exercise, countries will find it beneficial to follow regular and structured risk assessment steps. Depending on the country’s situation a variety of risk assessment approaches may be adopted. Tax administrations might use sophisticated computer systems to compare financial results with available comparable data as part of a process to identify specific cases as higher risk. Alternatively, tax administrations may select transfer pricing cases for audit every few years as a matter of routine, whether or not specific transfer pricing risk has been identified. In any event, it will be important for the country to have a clear sense of the types of information it should gather and review in the risk assessment process, what personnel should be responsible for conducting those reviews, and the nature of the questions the review will seek to answer.

17. It will generally be true that the more sophisticated the risk assessment system, the more insight it will provide in assessing the risk and the less likely it will be that audits will be unproductive and waste the tax administration’s limited resources. However, this does not mean that a highly sophisticated risk assessment system is suitable for all tax administrations and all situations. It should be recognised that it would also be true that the more sophisticated the risk assessment system, the more additional resource becomes necessary to establish and maintain the system. The level of sophistication that is suitable for a tax administration depends on the resources available for the risk assessment exercise in the tax administration, the size of the pool of taxpayers engaging in cross-border transactions with related parties, the exposure of the jurisdiction to transfer pricing risk, and the stage of the tax administration’s
development in transfer pricing enforcement. As noted above, it will be necessary to tailor the specific provisions of this Handbook to the situation of each tax administration.

18. A question often posed is whether transfer pricing risk assessment requires dedicated personnel with substantial transfer pricing experience, or whether risks can be assessed by audit staff with general responsibility for conducting a corporate tax audit. Judgement is especially important in the risk assessment process. Many countries have concluded that a centralised and specialised team should be used in conducting or at least reviewing assessment reports in the transfer pricing area. It is likely that specialisation will be essential in the risk assessment phase, and more important than specialisation is likely to be during the audit itself. Many countries have also found that interdisciplinary teams with tax, accounting, legal, and economic skills can be effectively deployed to conduct risk assessments.

19. The sections of this Handbook address the following questions: (i) what questions should the tax administration seek to answer in a transfer pricing risk assessment process; (ii) how can the tax administration evaluate whether a taxpayer presents a material transfer pricing risk that justifies a detailed audit; (iii) where can the tax administration get the information necessary to identify and assess transfer pricing risk; (iv) how can the tax administration organise itself to carry out an effective risk assessment; and (v) how can the tax administration most effectively interact with the taxpayer in assessing transfer pricing risk.
2. QUESTIONS TO BE ANSWERED IN A TRANSFER PRICING RISK ASSESSMENT PROCESS

20. The core objective of any transfer pricing risk assessment process will be getting answers to a few very fundamental questions. It is therefore essential to have a clear understanding of the questions to be answered before risk assessment is performed. In most cases, getting answers to the following questions is the goal of transfer pricing risk assessment.

2.1 Are there material controlled transactions?

21. The first question that needs to be answered in performing a transfer pricing risk assessment is whether there are controlled transactions with related parties. Any company which has either a major shareholder, parent company or subsidiaries is quite likely to be a party to transactions between related parties. However, if a company is owned by shareholders, none of which has a controlling interest, and does not have any subsidiaries, then all transactions undertaken by the company will likely be with independent persons, and there is unlikely to be any material transfer pricing risk, except certain cases.

22. It is important to note that in some situations actual transactions may have taken place, but no payment is recorded on the company’s books. An example might be a situation where valuable technical knowledge or know-how was in fact made available to a related party, but no transaction was recorded and no payment was made.

23. Another situation where transfer pricing related risk can arise in the absence of related party transactions being reported on the company’s books relates to operations through branches. Under the rules that usually apply for purposes of attributing income to branches, allocations of capital, interest, and imputation of dealings can take place even though transactions are not recorded in the books. Where a multinational enterprise (“MNE”) operates in the local country through a branch, or where one or more Permanent Establishments of non-resident members of the group are identified, a closer than normal review might be appropriate of whether transactions should be imputed and priced that are not reflected on the company’s books of account.

24. If there are transactions (whether or not booked or otherwise documented) between related parties, the second inquiry will be how material those transactions are. Generally, transfer pricing risk is directly proportional to the size of the cross border transactions between related entities. There may be more reason to devote audit resources to local taxpayers that make large payments to related parties, or receive small payments from related parties, than to those that make only small payments or receive large payments.

25. It should be noted that evaluating the transfer pricing risk arising from the size of transactions or classes of transactions should take into account both the size of the taxpayer and the magnitude of the transaction in the context of the particular country. A transaction that may not be material to the MNE group, and that would seem relatively small in the context of an audit in a large economy, may nevertheless be important if the country conducting the risk assessment has a smaller economy and fewer MNE groups doing business within its borders. Stated otherwise, materiality both to the country conducting the risk assessment and to the taxpayer should be considered.

2.2 Is there an indication of transfer pricing risk?

26. The second question that needs to be answered in performing a transfer pricing risk assessment is whether there is an indication of transfer pricing risk to tax administrations.
27. Tax administrations have transfer pricing risk where related party payments have the potential to shift income to other jurisdictions and erode the local tax base. Several factors might be considered in evaluating that possibility. One would be whether there are high level indications that the profitability of the local entity is not consistent with what might be expected of a similarly situated enterprise. A second indication may be whether the local member of the MNE group engages in material transactions with related entities in jurisdictions with low tax rates. Persistent losses reported by a local entity over a period of years may also indicate the existence of transfer pricing risk.

28. Another indication is whether the taxpayer makes large payments to related parties that have the result of eroding the local country tax base. The types of payments that raise such issues could include large royalty and rental payments, large management fees and other payments for related party services, payments to related parties for insurance, potentially transactions involving financial derivative contracts, and large payments of deductible interest.

29. Payments to related parties in other jurisdictions can take various forms, and often such payments will reflect arm’s length compensation for legitimate transactions. Assessing whether transfer pricing risk exists with regard to such payments will, therefore, require more than simply assessing whether such payments exist. The impact of such payments on the overall level of income reported by the local member of the MNE group should be considered together with the aggregate size of the transactions. Moreover, the consistency of the MNE’s global policies regarding such transactions should be considered.

30. In a similar vein, MNE group policies regarding allocation of risk within the group must be considered in connection with base eroding payments. Often, taxpayers will claim that a local member of the group is insulated from risk and should therefore be entitled only to low operating returns. Even those low returns, however, may be reduced by “below the operating income line” payments with respect to loans, other financial transactions, and depending on the transfer pricing method used, royalties, rents and management fees that may not be taken into account in evaluating the level of the income of the local enterprise vis a vis comparable uncontrolled enterprises. The result of a combination of low-risk operations and base eroding payments can be extremely low overall levels of income, which may warrant close review on audit.

31. Common practices to evaluate transfer pricing risk factors are described in detail in Section 3.2 below.

2.3 Is the case worth an audit?

32. Ultimately, the question being asked in a risk assessment process is whether the case, or certain aspects of it, warrants a thorough transfer pricing audit. A thorough transfer pricing audit is most likely to be resource-consuming. It will involve detailed research into the company’s business and the industry or sector in which it operates. It will probably entail forensic examination of documents such as transfer pricing reports, legal agreements and other business records. There will certainly be several meetings with the company personnel and its advisors. It will be useful, and at times essential, to involve specialists.

33. It is therefore important to consider the potential scale of the likely resource commitment and weigh that commitment against the potential additional tax revenue expected to be raised from the audit. Within the risk assessment process, potential cases should be examined to decide whether they warrant such a resource-consuming audit. All risk factors should be weighed in deciding whether the case should be selected for an audit or not.
2.4 What specific issues need to be addressed during the audit?

34. The risk assessment process does not end with a determination that there is material transfer pricing risk and that it is therefore worth pursuing an audit. The information developed in the risk assessment process can also be very helpful in giving direction to the actual audit regarding the issues that should be examined carefully and the information that needs to be developed to conduct a detailed investigation. Given that transfer pricing audits are usually resource-consuming for tax administrations as well as for business, a risk assessment can serve to focus any audit on the most important issues. In this respect, a risk assessment should consist of more than a mere recognition of facts suggesting the existence of transfer pricing risk; it should also consider the implications of those facts and identify specific questions that need to be considered during the actual audit.
3. ASSESSING WHEN TRANSFER PRICING RISK EXISTS AND WHEN IT DOES NOT

35. This section describes common practices among countries in assessing transfer pricing risk. The aim is to provide guidance on the particular issues that should generally be considered, the factors that suggest that transfer pricing risk to the tax administration may be high with regard to a particular taxpayer, and the manner in which various risk factors can be evaluated. It identifies the elements of the taxpayer’s transfer pricing profile that would trigger an evaluation that high transfer pricing risk may be present.

36. Countries have different methods of evaluating risk factors. Some will try to develop a rigorous quantitative evaluation of various risk factors and calculate risk “points” in order to determine which cases present the largest risks. Others will follow a more straight-forward approach, simply ranking various elements of a taxpayers transfer pricing profile as presenting high, medium or low levels of risk. In such a system, once the number of high risk elements exceeds a threshold, the tax administration will understand that a thorough transfer pricing audit should be conducted. Where there are only one or two high risk elements identified, however, the tax administration might conclude that a more targeted audit of the high risk items is called for.

3.1 Risk factors

37. Transfer pricing risk generally arises from one of three factors. First, such risk to the tax administration can arise because the taxpayer engages in recurring related party cross border transactions that have the potential to erode the local country tax base. Second, such risk can arise in connection with, or as a result of, certain large, one time transactions such as the transfer of intangibles or certain business restructurings. Third, such risk can arise because of inadequate taxpayer attention to general transfer pricing compliance. These risk factors are described more fully below.

3.1.1 Risk arising from recurring transactions

38. In some situations transfer pricing risk will be present because the taxpayer engages in recurring related party cross border transactions that have the potential of eroding the local country tax base. Such transactions can take many forms. They can simply consist of large volume sales or purchases of products or services. For example, if a local taxpayer in one of the extraction industries sells all of its local country output to related entities, small pricing discrepancies in each individual sale can add up to large reductions in the local tax base. Accordingly, recurring related party transactions will be one key risk factor.

39. It may be acceptable for the tax administration to disregard cases where the amount of tax at risk appears to be insignificant. In this context, it will be rational to have some quantitative transactional thresholds below or above which transfer pricing risk is deemed low, and cases are put aside from the candidates for audit. Common thresholds for this purpose would be based on the annual gross value of controlled transactions and/or income of the company.

40. However, recurring transactions alone will not necessarily indicate high risk. Other factors must be evaluated as well. In particular, consideration must be given to the nature of the transactions and the identity of the related parties participating in the transactions. For example, large total volume sales of commodity products may not raise concerns if they are priced in accordance with publicly available market data and if the sales are to related parties in high tax jurisdictions.

41. Certain types of transactions may create more cause for caution than others. In particular, payments with regard to certain hard to value items can raise concern. Payments of large total amounts of interest or insurance premiums to related parties, large total service and management fees paid to related
parties, and ongoing royalty payments to related parties for the use of technology, know-how, trademarks and brands or similar intangibles are all transactions that may warrant closer review. It should also be noted that where the local entity is the recipient of related party payments, such as service fees or royalties, risks can arise from the payments being small.

42. In addition to the nature of the payment, risk with respect to such transactions can be increased depending on the identity and likely tax attributes of the recipients of the payments. Accordingly, interest, royalties and service fees may be less troublesome where they are paid to a parent company in a high tax jurisdiction than if they are paid to intermediate affiliates in low tax jurisdictions. Moreover, it should be kept in mind that some jurisdictions have taxing and withholding rules that make companies organised in such countries useful as conduits. Accordingly, it is not sufficient to only consider the tax rate in the country of the recipient, but also to consider whether that recipient might simply be a useful conduit for shifting income to a low tax environment.

3.1.2 Risk arising from large or complex one time transactions

43. A different type of transfer pricing risk can arise in connection with certain types of large or complex one time transactions. Where a company engages in a business restructuring or a transfer of important income producing assets, the transaction has the potential of altering the transfer pricing relationships between group members for many years to come. Thus, the transfer pricing risk associated with such transactions may be much larger than the reported income numbers associated with the transaction in the year it is undertaken. Such transactions should generally be viewed as requiring additional scrutiny.

44. In addition, most transactions involving intangibles, including cost contribution arrangements, can create substantial transfer pricing risk to the tax administration for years to come and may warrant special scrutiny. Indeed, uncertainties around valuation with regard to such transactions can raise important transfer pricing questions even if there is no evidence of avoidance or minimisation of tax payments.

3.1.3 Risk arising from taxpayer behaviour in governance, tax strategies or ability to deliver compliance

45. A third type of risk factor in transfer pricing stems from the taxpayer’s behavior rather than the nature of its transactions. Insufficient compliance effort is one indicator of such risk. A taxpayer which gives insufficient attention to compliance, lacks fundamental information regarding the transactions it has undertaken, or which simply advises that “the parent company” is responsible for such things and the local entity has no data, can indicate the existence of a risk that transfer pricing outcomes are incorrect. Where a taxpayer has a history of noncompliance (whether involving transfer pricing or other issues) or of pursuing tax shelters or other aggressive tax strategies, it similarly indicates the existence of the risk.

46. Where a lack of cooperation or a low level of compliance is evident, and where there is evidence that sophisticated tax planning structures have been put in place, the risk level may be especially high. The business sector and/or corporate culture are elements to consider in assessing this type of risk factor.

47. Low compliance levels may not be particularly alarming if the size of related party transactions is low. Companies with few related party transactions likely will not have large transfer pricing issues and might therefore rationally conclude that they should direct compliance efforts to other topics. But if compliance efforts are low and transaction volumes are high, the level of the tax administration’s risk assessment evaluation should increase accordingly.
3.1.4 Quantifying the amount of tax at risk

48. In addition to the qualitative risk factors summarised above, a quantitative evaluation of the amount of potential tax at stake should form part of the risk assessment process. It is far more cost effective to target resources to cases where there is likely to be significant amount of tax at stake. Cost benefit analysis is key in any transfer pricing risk assessment. The risk assessment should evaluate what the likely amount of tax at stake is and how much tax administration resource will be required to establish the amount expected; and whether time would be better spent on another case.

49. The amount of tax at risk in respect of transactions between related parties should be judged by reference to the tax to which the party being under review is liable. The tax to which its associated entity is liable is not directly relevant. It is, however, indirectly relevant since there is more opportunity to secure a tax advantage through income shifting where there is a significant difference between marginal tax rates.

50. It may also be relevant to identify if there exists some systemic risk which needs to be addressed. For example, if there are a large volume of taxpayers engaged in relatively low value transactions, the underlying principle or issue may need to be evaluated through audit work to determine whether the systemic risk is greater than individual case risk.

51. Estimating the amount of tax at risk is not a formulaic process and judgment and understanding of the facts insofar as possible is required. However, it is a crucial part of the case selection process because it is essential to consider the potential tax which could be raised against the amount of enforcement resources required.

3.2 Evaluating transfer pricing risk

3.2.1 Risk indicators observed from related party transactions

52. In evaluating transfer pricing risk which arises from aforementioned risk factors, the following items observed from the related party transactions may indicate higher transfer pricing risk, and therefore, support a decision to conduct a thorough audit.

3.2.1.1 Profitability

3.2.1.1.1 In comparison to industry standards or potentially comparable companies

53. One strong indicator of higher transfer pricing risk will be if the financial results of the company under review substantially deviate from those of industry standards or potential comparable companies. Such deviations in profits from industry norms may suggest that transactions have not been correctly priced and the case is worth looking at in more detail. Obviously, there may be non-transfer pricing reasons for a company’s financial results deviating from industry norms. Therefore, low profits relative to industry standards can only be viewed as an indicator of higher risk, not conclusive evidence of mispricing.

54. Comparisons with industry standard levels of profitability are usually made by calculating and reviewing certain financial ratios. The following financial ratios are commonly computed and evaluated against the same ratios achieved by potentially comparable companies:

- Gross profit to net sales
- Operating profit to net sales
- Operating expenses to net sales
• Gross profit to operating expense (Berry ratio)
• Operating profit to average total assets

55. Standard industry financial ratios or those of potentially comparable companies are often sought in commercial databases. Experience and knowledge from past audits or advance pricing arrangements may also be helpful. Moreover, where contemporaneous transfer pricing documentation contains comparisons with identified comparables, such documentation can provide a valuable starting point for comparing the taxpayer’s financial performance with industry standards. (See Section 4 below for more guidance on sources of information.)

56. It needs to be emphasised that such high level profitability comparisons do not establish comparability. Commercial databases do not always provide segmented data of a company whereas, in principle, transfer pricing risk should ideally be evaluated on transactional basis. Typically, no comparability adjustments will be made at a risk assessment stage. As a result, decisive conclusions cannot be reached. Rather, the purpose of these comparisons is to test the general reasonableness of the outcomes of the taxpayer’s overall transfer pricing.

3.2.1.1.2 In comparison to related parties or group results

57. It can also be useful to look at the results of the company in comparison to those of the related party which is on the other side of the identified controlled transactions. If a disproportionate portion of the combined income from the transactions is allocated to either party, the functions performed, risks assumed, and assets used by such party should be similarly disproportionately weighted in the direction of that party. It should be noted that the effect on profitability from the risks borne by the parties, which might be substantial, is not easily encapsulated in financial ratios gathered at the risk assessment phase.

58. Similarly, it can be useful to look at the results of the company or a part of the group in the context of the whole of the group’s performance. This helps understand the nature of the group’s trade and how that trade is carried out. There are likely to be practical constraints on the availability of the data necessary to conduct such a review since the reporting rules in most countries would not necessarily require disclosure of the global allocation of the MNE group’s income. In those limited situations where data is available, however, consideration of the reasonableness of the results of local entity vis a vis the rest of the group can be helpful in evaluating risk.

59. Where the group as a whole is making losses, special cautions should be in place. It would not necessarily be correct that each member of the MNE group should attract its “fair share” of any losses. Each case should be looked at on its own facts. In many instances, a third party expects a profit for an activity irrespective of whether the person with whom it is trading is making a profit or a loss. If a loss-making group, for example, decided to outsource its warehousing, a third party might be engaged to provide those services. The third party would negotiate for the terms of the contract to be set in such a way that it would expect to make a profit. Allocation of losses will depend on the way risks and functions are allocated in the MNE group and may require consideration of several years of information.

60. If the group as a whole is making healthy profits and the local affiliate is making minimal profits, it might seem significant that the company’s results are worse than those of the group as a whole. However, at such a high level, this conclusion may be somewhat simplistic. The activities carried on by the company must be compared with what the group does elsewhere. If the company’s activities are the same as the group activities and it owns an appropriate proportion of the group’s intangibles, then a comparison of results may be valid. The company however may own little or nothing in the way of intangibles. If the company, for example, merely carries out contract manufacture for the group, and the
group owns valuable intangibles, then in all likelihood the company profit margin might well be lower than that of the group as a whole. Similarly, if the company is distributing well-known popular branded goods, and it does not actually own any of those brands, then its profitability will be likely to be lower than the group’s as a whole. The key here is to ask whether the activity is enjoying an arm’s length reward.

61. In some situations it may be possible to evaluate risk by comparing the profits or income the local affiliate derives from a transaction to the profits or income it might have earned in other transactions it might have entered into. For example, if an entity hires an affiliate to perform manufacturing services on its behalf, and the fees it pays for the manufacturing services are substantially higher than the costs the entity incurred carrying on the same manufacturing services on its own account in earlier years, further investigation of the arm’s length nature of the outsourcing arrangement may be in order.

3.2.1.1.3 Recurring losses, recurring low profits, or recurring low returns on investment

62. The company’s financial performance over time can also be an important risk indicator. Continuous losses, where there is no attempt made to change business operations or financing, may be evidence that the reported results do not reflect the true value of the business. Losses or low profits over a period of years can therefore indicate transfer pricing risk.

63. Some business activities might be expected to make profits from the outset. For example, a company engaged in commercial contract research and development would likely expect to move into profit shortly after starting to trade – this is the nature of contract activity. Similarly, a company providing services in the form of technical assistance would expect to charge for those services at prices that yield a profit more or less straight away.

64. It should be recognised, however, that losses over a period of a few years might be justified under the arm’s length principle. This might particularly be the case with regard to start-up operations. In other situations, a group policy directed at trying to break into a new market or introduce a new product by selling at a loss in order to gain market share could be in place. The introduction of a new product will often involve initial heavy marketing expenditure to establish the brand in the market. Depending on what functions and risks the distributor takes on, initial losses might be acceptable for a certain period, but independent distributors would likely expect to move into profit as quickly as possible.

3.2.1.1.4 Fluctuation contrary to market trends

65. Profit trends of a company that are contrary to market trends may also represent a risk indicator. Such profit trends can be evidence that the conditions of the local company’s controlled transactions have not been consistent with arm’s length conditions. For example, if the market for the company’s products is expanding rapidly, and if sales are similarly growing quickly, but the local entity’s profits are low, the question arises whether it is receiving an appropriate share in the success of the business. Profit trends contrary to market trends can, therefore, be a result of misapplication of transfer pricing methods, negligence in pursuing changes of contractual conditions that should have been occurred if they were between independent parties, or a diversion of profits to lower-tax jurisdiction.

3.2.1.1.5 Substantial or disproportionate income in low-tax jurisdictions

66. It is often very helpful to understand an MNE’s overall income attribution among its group companies in order to assess its overall tax policy and hence the level of transfer pricing risk existing in connection with the MNE. Where data on income allocation among countries is available, a large allocation to lower tax jurisdictions where few economic activities take place would be among the strongest indicators of transfer pricing risk. As noted above, gaining access to the data required for such an evaluation may be particularly difficult.
3.2.1.2 Transactions with related parties in low-tax jurisdictions

67. Where transactions take place with related parties in a low-tax jurisdiction, there is a risk that mispricing will incorrectly attribute excess profits to the low-tax jurisdiction. If a related entity that is the other party to the cross-border controlled transactions is located in a low-tax jurisdiction, careful consideration should be given to the possibility that a thorough audit is required. It should be noted that the existence of transactions with related parties in low tax rate jurisdictions is not, in and of itself, conclusive evidence that non-arm’s length pricing exists. Problems with transfer pricing policies are more likely to exist, however, and transfer pricing risks are therefore higher, when large transactions with low rate jurisdictions are present.

68. Similar risks might also exist when large transactions are observed with jurisdictions whose tax rules and treaty policies facilitate the use of entities in those jurisdictions for pass through payments. In the same vein, some countries seek to attract inward investment by granting lower levels of tax, exemption from tax, or tax holidays on the profits of certain activities. There is a possibility that for tax reasons pricing may be set so that profits arise in a location where those profits will be subject to such an incentive or tax holiday provision. Thus, it is important to evaluate the specific facts of particular transactions, and not simply generalize about whether the other party to the transaction is located in a low-tax jurisdiction.

69. Even if there are commercial reasons for trading with or in low-tax jurisdictions, it may be sensible when looking at risk indicators for selecting a case for audit to treat any sizable transactions with a related party in a low-tax jurisdiction as having a high potential for non arm’s length pricing.

3.2.1.3 Intra-group service transactions

70. Intra-group service transactions may be one of the most frequently occurring transfer pricing issues. Depending on the nature of these service transactions and the charges made for them, the issues can have either large or limited significance. Parent companies or regional headquarters offices often provide administrative or other general services for members of the MNE group. While several hard to resolve issues can arise in connection with such transactions, often the amounts involved may not be sufficiently large to warrant a great deal of audit resources.

71. In other situations, the amount of overhead charge may be quite large compared to the size of the local subsidiary. Even when such services are charged at cost or at cost plus a small mark-up, questions may arise as to whether the level of the overhead charge is appropriate to the size of the subsidiary. In such situations, consideration should be given to the nature of the benefits being provided.

72. In other situations, intra-group service transactions can be very large and important to the operation of the company. These non-routine types of services can often be difficult to value and may raise significant transfer pricing issues. In this respect they are not unlike other large related party transactions and the assessment of risk will depend on the materiality of the transactions, the nature of the party providing the services, the amounts charged for the services, and the tendency of the transactions to otherwise erode the local tax base.

73. It should be noted that experience has shown that intra-group service transactions (including high value service transactions) are often not fully documented.

3.2.1.4 Royalty, management fees, and insurance premium payments, particularly to entities in low tax jurisdictions

74. Excessive royalties, management fees, and insurance premiums paid to related parties can be used to erode the local company tax base. Similarly, where the local entity is the recipient of such
payments, small amounts related to royalties, management fees, and the like can reflect transfer pricing risk. Underlying rights in intangibles and the assumption of risks that support such payments can be assigned by contract in a way that may not correspond to the economic substance of the relationship between the parties. Consequently, there is a risk that such payments may be over-stated or under-stated in order to shift income to lower tax jurisdictions. This can especially be the case when a company makes several different kinds of such payments. In combination, they can substantially reduce the local country tax base.

3.2.1.5 Marketing or procurement companies located outside market countries or countries where manufacturing takes place

75. Where a marketing company is located outside the country where the MNE’s customers are located, or a procurement company is located outside the country where manufacturing takes place, transactions involving these intermediaries may also tend to reduce income in the local jurisdiction. There is a risk in these types of transactions that the taxpayer is following a strategy of accumulating income in such intermediary companies, in excess of the income that can be justified by the economic activity in those companies. Such arrangements may, therefore, represent a risk indicator that deserves further examination to assure that the income allocated to such operations is in line with the actual services being provided.

3.2.1.6 Excessive debt and/or interest expense

76. Debt that appears to be in excess of the amount that an entity could borrow if it were a free standing entity, or interest expenses that appear to be in excess of those based on typical borrowing levels and interest rates may indicate transfer pricing risk. Excessive debt can be used to erode the tax base, particularly when the interest is paid to related entities in low-tax or conduit jurisdictions. Particularly where transactional net margin method (“TNMM”) is applied to define an arm’s length level of operating income, care needs to be taken that such income is not unduly reduced by interest expense that is not considered in the TNMM analysis.

77. The legal approach to the issue of excessive debt may vary among countries. In some countries it may be governed by the arm’s length principle, whereas other countries may have statutory thin capitalisation rules. Interest rates are subject to regulation under transfer pricing rules in virtually all countries. Consideration of the company’s debt structure and interest payments should, therefore, usually be part of a transfer pricing risk analysis.

3.2.1.7 Transfer or use of intangibles to/for related parties

78. An intangible may be of great significance because the economic return on the intangible can be substantial. When income-producing intangibles are transferred, determining their arm’s length value is crucial. Sometimes, a parent company may support its subsidiary in its manufacturing and marketing efforts. In doing so, the parent may transfer a bundle of intangibles to the subsidiary. A bundle of intangibles may consist of two or more individual intangibles. In these cases, the different individual intangibles that are being transferred may need to be valued in the aggregate.

79. A taxpayer that is a member of a group may have acquired, created or enhanced an asset that is used by other group members, by incurring expenditure on research and development leading to the creation or enhancement of intellectual property. In such a case, the absence of royalties or fees in a company owning valuable intangibles, or the lack of significant profits may be an indication that the transfer pricing of controlled transactions is not on an arm’s length basis. A group of companies may own many different types of intangibles, spread amongst different members of the group.
The following are some common indicators that a company owns valuable intangibles:

- The company produces well-known branded goods, such as clothes, food, drink, accessories, etc.
- The company accounts show significant amounts spent on research and development.
- The company routinely seconds highly-qualified or skilled employees to other group companies.
- The very nature of the work carried out by the company produces valuable intangibles, such as a proprietary trading platform or system.
- The company name is prominently used by a website registered by a different company.

When these factors are present and important, they can indicate a transfer pricing risk that requires further examination.

**3.2.1.8 Cost contribution arrangements**

Cost contribution arrangements (“CCAs”) can also raise difficult issues that require proper judgement. A CCA is a framework agreed amongst business enterprises to share the costs and risks of developing, producing or obtaining assets, services, or rights, and to determine the nature and extent of the interests of each participant in those assets, services, or rights. In a CCA, each participant’s proportionate share of the overall contributions to the arrangement must be consistent with the participant’s proportionate share of the overall expected benefits to be received under the arrangement. Therefore, if a taxpayer that is a member of a group enters into a cost contribution arrangement with other group members with no clear expectation of a future income stream that is commensurate with its obligation to share costs, then income allocation among the participants will be inconsistent with the arm’s length principle.

A common use of CCAs involves the joint development of intangibles. In such arrangements it is often important to consider whether the payments made at the beginning of the CCA to share intangibles and other capabilities are arm’s length. These arrangements often require transfer pricing audit, because they will have consequences for years to come and can be used to migrate intangibles among group members at less than arm’s length prices.

**3.2.1.9 Business restructurings**

Transfer pricing issues arising with regard to business restructurings can be very complex and require a thorough transfer pricing audit. The business structures and transaction flows adopted in connection with restructuring an MNE’s business need careful consideration. There are two aspects of such transactions to be considered. The first is the restructuring transaction itself. The transfers of assets, including intangibles, in connection with such transactions can give rise to difficult valuation and other transfer pricing issues. Often these transactions involve efforts to move valuable assets into more tax-favoured environments. A risk assessment should seek to identify such transactions and evaluate the potential exposures. The second set of issues arising in connection with a business restructuring involves the ongoing transactions following the transaction which flow from the restructuring. These may involve any of the types of transactions described in the sections above and can raise the same types of risks. The following are some particular indications of high risk in a business restructuring context:

- Accounts for activities such as distribution or manufacturing show a sudden drop in profit margins as a result of the restructuring.
• There is an acquisition of new businesses in a fragmented fashion where valuable intangibles end up in a group company based in a low-tax jurisdiction.

3.2.2 Non-tax factors that may distort pricing

84. There are non-tax factors that might provide an incentive for improper transfer pricing. Regulatory requirements involving customs valuations, anti-dumping duties, currency exchange or price controls, or cash flow incentives within a group resulting from business management policies regarding where profit is reported or how dividends are financed may result in inaccurate transfer pricing in order to go around such regulatory requirements. The risk assessment process should include an effort to identify these non-tax risk objectives in the management policies of a group.

3.2.3 Quality of contemporaneous transfer pricing documentation

85. The quality of contemporaneous transfer pricing documentation can be an indicator of the transfer pricing risk. Evidence that transfer prices and the methods used to compute them are inadequately recorded may cast doubt on the reliability of the prices themselves.

86. Some countries assess the quality of a documentation to inform the decision whether to proceed to a transfer pricing audit.¹

87. The following table from the FTA publication “Dealing Effectively with the Challenges of Transfer Pricing” summarises the guidance set out above. This practical checklist of important issues to be considered in a transfer pricing risk assessment can be a very helpful tool for tax administrations in organising their risk assessment processes.

<table>
<thead>
<tr>
<th>Feature</th>
<th>Brief Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Significant transactions with related parties in low tax jurisdictions</td>
<td>Where transactions take place with low taxed related entities there is a risk that mispricing will incorrectly attribute excess profits to the low taxed jurisdiction.</td>
</tr>
<tr>
<td>• Transfers of intangibles to related parties</td>
<td>Transactions of this nature raise difficult valuation questions, especially where the intangibles are unique and consequently there is a lack of comparables.</td>
</tr>
<tr>
<td>• Business restructurings</td>
<td>The transfer pricing aspects of business restructurings were the subject of a specific OECD study published and incorporated as a new Chapter IX of the Transfer Pricing Guidelines in July 2010.</td>
</tr>
</tbody>
</table>

¹The Australian Tax Office assesses the quality of a business’ processes and documentation, and the commercial realism of the outcomes of its dealings. It then decides whether to proceed to a transfer pricing audit. The quality of a business’ processes and documentation is assessed as falling into categories, ranging from low, which will increase the likelihood of an audit, to high, which will decrease the likelihood of an audit. See the ATO publication “International transfer pricing - introduction to concepts and risk assessment” available at www.ato.gov.au.
• **Specific types of payments**
  Payments of interest, insurance premiums and royalties to related parties raise transfer pricing risks because the underlying rights are highly mobile and consequently there is a risk that the payments do not reflect the true value being added by the related party.

• **Loss making**
  Year on year loss making where there is no attempt made to change business operations or financing. Sustained losses may be evidence that the reported results do not reflect the true value of the business.

• **Poor results**
  Similarly results that are not consistent with industry norms or with the functions carried on by the enterprise in the country concerned may be evidence that related party transactions have not been correctly priced.

• **Effective Tax Rate**
  Significant variations between the effective tax rate reported at group level and the nominal rates to which it is subject can be the result of transfer pricing that allocates too much profit to low tax jurisdictions.

• **Poor/Non-existent Documentation**
  Evidence that transfer prices and the methods used to compute them are inadequately recorded casts doubt on the reliability of the prices themselves.

• **Excessive Debt**
  Debt that appears to be in excess of the amount that an entity could borrow if it were a free standing entity, or interest rates that appear to be in excess of market rates.

### 3.2.4 Indications of low transfer pricing risk

88. Some facts can suggest a low level of transfer pricing risk. One obvious indication of low risk is a low volume of controlled transactions. The following considerations may also indicate that transfer pricing risk is low. Where such facts are present, it may be possible to determine that thorough audits are not necessary at an early stage of the risk assessment process.

- A local taxpayer has significant unrelated minority shareholders whose interests would be prejudiced by the diversion of profits to the majority shareholder.

- A taxpayer has transactions with a related party in a jurisdiction with a greater marginal tax rate. In such a case, although the possibility of misapplication of transfer pricing rules may need to be considered, there will usually be little motivation for taxpayers to manipulate transfer prices to the disadvantage of the local jurisdiction.
• A taxpayer enters into transactions with unrelated parties on similar terms to those it enters into in equivalent transactions with related parties. In such a case, the tax administration would only need to examine the comparability of the transactions with unrelated parties, or might conclude that no audit is required at all.

• A taxpayer is a member of a group which maintains consistent transfer pricing policies which are compliant with the arm’s length principle across all jurisdictions in which the group conduct its businesses.

• Clear evidence of a preponderance of uncontrolled transactions (for example significant transactions with unrelated participants and no offsetting transactions between the unrelated taxpayer and other related affiliates).
4. SOURCES OF INFORMATION FOR CONDUCTING A TRANSFER PRICING RISK ASSESSMENT

89. One of the most important issues in conducting a transfer pricing risk assessment is finding the right information to evaluate transfer pricing risk as discussed above. Evaluating transfer pricing risk requires knowing the taxpayer, its global business, and its industry. There are many sources of information that tax administrations can and should access for this purpose. This section illustrates the information sources available to conduct a transfer pricing risk assessment.

90. The starting point for any risk assessment process would be a review of the tax returns themselves, including any required information returns filed by taxpayers. The taxpayer’s tax filings can be supplemented by a systematic review of information available from other sources within the tax administration and information in the public domain. Tax administrations are increasingly using a range of data and expertise to refine their analysis and improve their assessment of transfer pricing risk.

91. Tax administrations usually use a combination of data sources discussed below to identify indicia or features of risk which inform their transfer pricing risk assessments. Using a range of sources can ensure that less obvious risks are not overlooked, at the same time it can also allow for cross-checking which can help to eliminate potential issues that are in fact not worth pursuing. The quicker risks and concerns can be ruled out, the more resources can be focused on risks and taxpayers which do need further attention.

4.1 Specific tax return disclosures – information returns

92. Many tax administrations require taxpayers that (i) are subject to tax in their country and (ii) carry out controlled transactions, to supplement their tax return with forms or other reports that disclose additional information relevant to transfer pricing arrangements. Although they may vary in the breadth and depth of information they demand, the information required in such forms will often include the following:

- Identification of related party transactions
- Identification of related parties with which controlled transactions are carried out
- Nature and amount of controlled transactions carried out with each related party
- Segmented financial results of each controlled transaction
- Description of the differences between a taxpayer’s financial statement and its income tax return income (i.e., book / tax differences)

93. The information obtained from such forms largely consists of quantitative information, and often will be processed in a computerised database system at the earliest stages of a risk assessment process. Annexe 1 to this Handbook exhibits some existing forms currently used by tax administrations.

94. A common complaint of business is that the continuing proliferation of these types of information reports, and the failure of countries to conform the format of the required responses, puts a significant administrative burden on taxpayers. The OECD is currently exploring, in connection with its transfer
pricing simplification project, the extent to which some uniformity could be established in the nature of the information called for in these information reporting rules and the required format for responses.

95. Countries should recognise, however, that information regarding the nature and amount of related party transactions, and the identity of the related parties participating in those transactions, is not widely available in public documents. Since this information is essential to reaching informed conclusions in a risk assessment, countries should consider whether their own reporting rules are sufficiently robust to provide access to the kind of information that would help determine the nature and amount of related party transactions.

4.2 Contemporaneous transfer pricing documentation

96. Many countries also require taxpayers carrying out controlled transactions to prepare a package of contemporaneous transfer pricing documentation. Such documentation generally includes basic factual descriptions of the transactions and operations, a description of the most appropriate transfer pricing method to use to test the arm’s length nature of the transfer prices charged, and a detailed application of that method to the facts of the case demonstrating the taxpayer’s position as to why the pricing of the transactions conforms to the arm’s length principle. The documentation generally will also include the financial data required to support the economic analysis. Where such documentation is available and carefully prepared, it supplements with in depth analysis the information disclosed in the transfer pricing forms and tax returns.

97. In recognition of the fact that taxpayers can be greatly burdened by the various country requests for contemporaneous transfer pricing documentation, the OECD is also considering, in connection with its transfer pricing simplification project as mentioned above, whether there are ways to simplify compliance and provide the necessary information with less burden to taxpayers.

98. Generally, transfer pricing documentation requirements seek the following types of information:

- An overview of the taxpayer’s and its group’s business
- A description of the taxpayer’s organisational structure covering all related parties engaged in controlled transactions
- Individual financial data of the taxpayer and consolidated financial data of its group as a whole
- A functional analysis of the controlled transactions describing the relevant functions, risks and assets of the various parties to the controlled transactions
- A description of the transfer pricing method selected, including an explanation of why the taxpayer believes it to be the most appropriate transfer pricing method for the transactions at issue, and the alternative methods that were considered and an explanation of why they were not selected
- A description of the comparables used in the economic analysis, including an explanation of how comparability was evaluated
- An explanation of the economic analysis and any financial projections relied upon in developing and applying the transfer pricing method
99. In order to enable an accurate transfer pricing risk assessment, the tax administration should carefully consider its contemporaneous documentation requirements. Often the very fact of preparing such documentation will tend to reduce the level of transfer pricing risk, when taxpayers are required to disclose transactions and analyse the most appropriate way of establishing arm’s length prices or demonstrating that the prices charged are consistent with the arm’s length principle.

4.3 Questionnaires issued to selected taxpayers

100. Some tax administrations send a questionnaire to selected taxpayers after an initial review of the tax returns filed by taxpayers. In general, this tool seems to be most often utilised in countries where there is no statutory contemporaneous documentation requirement. These questionnaires ask for additional information regarding transactions with related parties, to help complete the risk assessment process.

101. Annex 2 to this Handbook exhibits some examples of existing supplementary questionnaires used by tax administrations.

4.4 Taxpayer’s file and audit records of previous years

102. The Taxpayer’s file maintained in the tax administration, and previous years’ audit records and risk assessment reports may contain useful information which will help build a complete picture of the business activities. In particular, previous years’ audit records should contain helpful information to determine how to focus the audit process if it is decided an audit should be conducted.

4.5 Publicly available information regarding the taxpayer

4.5.1 Internet searches

103. Using the Internet can provide information about particular companies or industries. It is also possible to use the Internet to access some government agencies’ databases that are open to the public.

4.5.1.1 Taxpayers’ websites

104. Most companies have their own websites. MNE groups usually have a very comprehensive website, providing a wealth of useful information. Such websites will certainly promote what the group does – services it provides or goods it sells. Major products or brands will likely be extensively described. The section on investor relations will contain the latest and prior year’s financial statements as well as latest half-yearly or quarterly figures. These will likely provide information on the MNE’s overall effective tax rate. There may be copies of presentations by senior staff to business analysts, investors and credit rating agencies – these may give useful information on forecasted sales and new products.

105. There will also normally be a link to press releases, which might provide information such as new products, products being sold, and factories opened or closed. The site may provide information on where activities are carried out around world. Sometimes there will be detailed explanations of research and development efforts. Invariably there will be details about job vacancies, which will provide a clue as to the location of key personnel, and what they do.

106. Such information can be used to confirm the accuracy of the functional analysis in the contemporaneous documentation and to check some of the facts described by the MNE to tax authorities. One shortcoming of such data, however, is that it will rarely describe individual activities of the individual entities that make up the MNE group. Publicly disclosed annual report data is generally prepared from the perspective of the group as a whole, rather than from the perspective of individual legal entities.
4.5.1.2 Government agency databases

107. Documents filed with other government agencies can sometimes be found on the Internet. For example, a publicly-quoted corporation in the United States has to file a series of documents each year to the Securities and Exchange Commission. The documents contain a detailed three-year summary of the business activities, acquisitions and disposals, research and development, and information on major agreements with third parties. These can be a useful source for analysis of potential comparables. Canada has a similar system. It may be important for the tax administration to extend its search beyond documents filed with its own country’s agencies, particularly by looking at filings in the MNE’s home country.

4.5.2 Commercial databases

108. Commercial databases take information from a variety of publicly available sources and provide a way of finding companies that are carrying out broadly similar activities to the company under review. In some countries and in some situations, it can be useful to try and find similar but independent companies carrying out broadly similar activities, and compare their financial results to those of the company under review. For the purpose of transfer pricing risk assessment, the search may be fairly general, being used primarily to survey broadly how the company is performing in comparison with similar companies.

109. A database search might show that the company under review is completely outside of the range of potential comparables, which will be an indicator that the case is worth looking at in more detail. Alternatively, the company may be near the top or even outperforming the comparables, which probably, though not necessarily, means that time will be better spent focusing on other potential targets for a transfer pricing audit.

110. In some countries, the absence of a large base of independent companies filing financial data with government agencies will make commercial databases less useful. Regional comparables may be considered but careful attention should be given to differences between companies in the data base and those in the local market. Experience in transfer pricing risk assessment can greatly enhance the ability of the tax administration to draw meaningful conclusions from data relating to regional comparables.

4.5.3 Press reports, trade magazines, etc.

111. Press reports, trade magazines and other information in the public domain can provide useful information on both particular companies and the sectors to which they belong. Information on business sectors can help decide whether declining results for a company reflect a wider malaise for that particular business sector, or reveal that the sector was in fact rather buoyant during the period in question. Articles on business sectors may also indicate when a competitor has launched a rival product, which might explain a fall in sales for the company being reviewed.

112. Press reports on individual companies would provide information about the launch of new products, factories opening or closing, strategic partnerships or alliances the MNE is entering into and sometimes even concrete information such as royalty rates on licence agreements they have concluded.

4.5.4 Securities analysts’ reports

113. Securities analysts’ reports provide analyses on individual corporations, entire industries, and general economic trends. They provide analyses of financial information to forecast business, industry, or economic condition. Securities analysts often specialise in a single sector or industry, and use a wide variety of techniques for conducting research to support quantitative analyses of information. They monitor developments in the fields of industrial technology, business, finance, and economic theory, and
assess the earning potential of a company or industry. Their interpretation of data on price and yield may help understand the company or industry.

114. In some cases securities analysts require payment of fees for access to their reports. In other situations, however, meaningful data may be available without charge.

4.6 Site visits and meetings with company personnel

115. A meeting with company personnel is usually considered essential during the course of an audit. In some situations, such a meeting can also be quite helpful at a risk assessment stage, particularly with large MNE groups. A meeting during a risk assessment process could provide an opportunity to establish that the transfer pricing of some controlled transactions is low risk. If an audit is decided to be undertaken, the meeting may provide sufficient information to permit the tax authorities to focus the audit from the outset.

116. A common complaint from taxpayers may be that auditors do not understand their business and either ask for too much information or ask irrelevant questions. A meeting at a risk assessment stage can therefore be productive for all concerned.

117. Typically it would be prudent to review tax returns, other filings, and contemporaneous documentation in advance of the meeting to develop background and a set of questions to be discussed with the taxpayer. It will not be necessary to conduct a site visit or meeting with the taxpayer in every case. But where the initial stages of a risk assessment yield questions that the tax administration wishes to have answered, a meeting may be the quickest and simplest way to get those answers.

118. In some countries it is possible to discuss difficult transfer pricing issues with the tax administration prior to the filing of the return, which ensures that those issues are identified without any delay. See Section 6 below for more description.

4.7 Customs data

119. It is possible to use data collected for the purposes of assessing customs duties to obtain details of cross border transactions, including those between associated enterprises. It is often the case that customs data will be collected and available in real time. However, it should be noted that customs pricing and arm’s length pricing are usually not the same. The existence of a cross-border movement of goods is not always indicative of a transaction, as goods often move within a group without change of ownership, and other transactions, such as royalty flows, do not show up in customs data. Moreover, without knowledge of the ownership of the intangibles associated with many goods, it can be difficult to assess instances of under or overvaluation. Thus, customs data will be useful in connection with other information, but will not usually be a satisfactory exclusive source of data for risk assessment purposes.

4.8 Patent office

120. Some countries try to build a closer working relationship with the country’s patent office in order to help identify cases where cross border transfers of intellectual property have taken place and to obtain a better understanding of what intellectual property a business is developing. However, patents can be very difficult to understand, and it needs to be recognised that many transfers of intellectual property within a group take place by licence without any notification of transfer to official registries.
4.9 Exchange of information under tax treaties

121. Information received from other tax administrations, either automatically or as a result of a request, may assist in identifying transfer pricing risk. In particular, automatic exchanges of information under double tax treaties have been found very productive in some countries in identifying, and therefore tackling, transfer pricing risk. They are beneficial as information is exchanged at the earliest opportunity ensuring that the deadline for opening a transfer pricing audit is not missed.

122. Where specific requests for information are made under treaties, the tax administration should be sure that it will have sufficient time to allow the request to be processed and for the information, once received, to be used in a meaningful way in the risk assessment process. The more specific the information request, the more likely it will be to yield useful data.

4.10 Necessary legal provisions to facilitate access to information

123. Not all sources of information listed above require special provisions to permit the tax administration to utilize the data. For example, the taxpayers’ file and audit records of previous years are already in possession of tax administrations, Internet sites are free to access, and commercial databases can be accessed once a subscription fee is paid.

124. Information returns and contemporaneous transfer pricing documentation require that specific requirements be enacted into law. In other words, these two sources usually constitute principal sources of information for a risk assessment process because tax administrations are able to decide what information should be disclosed and how detailed the disclosures should be. Tax administrations should carefully consider the level of detail for such information in prescribing the provisions requiring such disclosure.

125. In addition to the information returns and contemporaneous documentation, it would be worth noting that legal provisions will be necessary to support obtaining the following useful information.

4.10.1 Obtaining information relating to foreign associated enterprises

126. Other than information returns and documentation, there are two other possible ways to obtain information relating to foreign related parties; requesting tax administrations of the other country to exchange information under the double tax treaty, and requiring the taxpayer to make such information available to the tax administration as a condition of doing business in the country.

127. The OECD Model Tax Convention provides in Article 26 the authority to exchange information between tax administrations. Provided there is a double tax treaty with the other country, a tax administration is able to request to the tax administration of the other country to provide information relating to foreign related parties of the taxpayer under review.

128. Local law may also provide the tax administration authority to require taxpayers to provide information of their foreign related parties. Some countries have provisions for this purpose in their legislation. Annex 3 to this Handbook exhibits some of such provisions existing in counties’ legislation.

4.10.2 Obtaining information relating to domestic potentially comparable businesses

129. The most common tool for obtaining information relating to potentially comparable businesses is probably commercial databases. In fact, a number of them provide features specifically focused on transfer pricing analyses. However, in some countries, there is also a legal authority to allow tax administrations to obtain information directly from potentially comparable domestic businesses. This authority is different from the enforcing power exercised for conducting audits because the business subject to such disclosure
requirements is not the taxpayer subject to the audit. This type of authority may be a useful tool for tax administrations as they can obtain much more in depth, focused and precise information about domestic potentially comparable businesses which cannot be obtained from commercial databases. It should be noted, however, that this type of authority is normally exercised with certain restrictions.

130. Annex 4 to this Handbook exhibits some of the existing provisions providing such authority in countries’ legislation.

131. The following table expands the table of useful questions in a transfer pricing risk assessment contained in Section 3 of this Handbook. It adds to the issue identification a summary of where the tax authority is likely to be able to find information related to the issues in question.

<table>
<thead>
<tr>
<th>Feature</th>
<th>Brief Description</th>
<th>Where to look</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Significant transactions with related parties in low tax jurisdictions</td>
<td>Where transactions take place with lowly taxed and related entities there is a risk that mispricing will incorrectly attribute excess profits to the lowly taxed jurisdiction.</td>
<td>Information return (Form) Contemporaneous documentation</td>
</tr>
<tr>
<td>• Transfers of intangibles to related parties</td>
<td>Transactions of this nature raise difficult valuation questions, especially where the intangibles are unique and consequently there is a lack of comparables.</td>
<td>Information return (Form) Contemporaneous documentation Financial accounts Patent office</td>
</tr>
<tr>
<td>• Business restructurings</td>
<td>The transfer pricing aspects of business restructuring were the subject of a specific OECD study published and incorporated as a new Chapter IX of the Transfer Pricing Guidelines in July 2010.</td>
<td>Information return (Form) Contemporaneous documentation Taxpayer’s website Financial accounts Press reports / trade magazines Securities analysts’ reports</td>
</tr>
<tr>
<td>• Specific types of payments</td>
<td>Payments of interest, insurance premiums and royalties to related parties because the underlying rights are highly mobile and consequently there is a risk that the payments do not reflect the true value being added by the related party.</td>
<td>Information return (Form) Contemporaneous documentation Financial accounts</td>
</tr>
<tr>
<td>• Loss making</td>
<td>Year on year loss making where there is no attempt made to change business operations or financing. Sustained losses may be evidence that the reported results do not reflect the true value of the business.</td>
<td>Information return (Form) Contemporaneous documentation Financial accounts</td>
</tr>
<tr>
<td>• Poor results</td>
<td>Similarly results that are not consistent with industry norms or with the functions carried on by the</td>
<td>Information return (Form) Contemporaneous documentation Financial accounts</td>
</tr>
</tbody>
</table>
enterprise in the country concerned may be evidence that related party transactions have not been correctly priced.

**Effective Tax Rate**

<table>
<thead>
<tr>
<th>Significant variations between the effective tax rate reported at group level and the nominal rates to which it is subject can be the result of transfer pricing that allocates too much profit to low tax jurisdictions.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Contemporaneous documentation</td>
</tr>
<tr>
<td>Consolidated financial accounts</td>
</tr>
</tbody>
</table>

**Poor/Non-existent Documentation**

<table>
<thead>
<tr>
<th>Evidence that transfer prices and the methods used to compute them are inadequately recorded casts doubt on the reliability of the prices themselves.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Contemporaneous documentation</td>
</tr>
</tbody>
</table>

**Excessive Debt**

<table>
<thead>
<tr>
<th>Debt that appears to be in excess of the amount that an entity could borrow if it were a free standing entity, or interest rates that appear to be in excess of market rates.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Information return (Form)</td>
</tr>
<tr>
<td>Contemporaneous documentation</td>
</tr>
<tr>
<td>Financial accounts</td>
</tr>
</tbody>
</table>
5. RISK ASSESSMENT PROCESS – SELECTING CASES FOR TRANSFER PRICING AUDIT

5.1 Appropriate tax administration organisation for conducting risk assessments

132. Countries with advanced risk assessment processes organise themselves in different ways to conduct risk assessments. A first question for the tax administration to consider is whether risk assessment should be conducted on a centralised or decentralised basis. Having a centralised risk assessment team allows the application of more consistent standards, it allows the risk assessment group to develop experience and judgment, and it assures that the best available people in the tax administration will be considering the risk to the administration in various transfer pricing contexts.

133. Problems can arise with a centralised approach, however, if the resources of the centralised team are stretched too thin. It may be more challenging for a centralised team to interact with the taxpayer to get needed information. And if the case load of the risk assessment group gets to be too large, then the ability to conduct a risk assessment on a timely basis can be compromised.

134. Some countries have tried to follow a middle course by engaging local auditors to gather information for the risk assessment and provide an initial evaluation of that information. They then require a central board or review committee to consider the outcome of this initial assessment, ask questions and seek additional information, and sign off on any decision to go forward with either a thorough transfer pricing audit or a targeted audit of certain issues. In these countries, a transfer pricing audit may not be opened, or any approach made to a taxpayer that might be construed as the opening of a transfer pricing audit, without the prior approval of the central review committee. Countries following such review procedures often use a standard template and a narrative document which sets out the case background, the risk assessment work undertaken, the reasons for and against examination and any special features in a concise form for consideration by the central review committee.

135. Each country will need to determine which of these approaches works best in its own circumstances. In making such decisions it will be necessary to consider the number of cases, the availability of committed resources, the ability of the tax administration to manage internal communication efficiently, and a number of other things. Most countries have continued to experiment with different structures over time and countries should not feel that initial structural decisions cannot be changed if experience suggests that improvements can be made.

5.2 Procedures and steps for conducting a risk assessment

136. It is important that a risk assessment process be consistent and regular and that all personnel involved have a clear understanding of that process. It is also important to understand that the process should proceed one step at a time with judgment being exercised in every step about whether and how to move forward. Common steps in the risk assessment process can include the following:

- Assembling quantitative data from tax returns, transfer pricing forms and contemporaneous documentation provided by the taxpayer
- High level identification of possible transfer pricing risk by analysing processed quantitative data
- High level quantification of potential risk
• Reviewing qualitative information in contemporaneous information and gathering of additional intelligence from public sources

• Tentative decision as to whether to proceed

• More in depth risk review including analysis of functional and comparability descriptions in contemporaneous documentation

• More detailed quantification of potential risks

• Initial interactions with taxpayer personnel

• Preparation of draft risk assessment report

• Decision as to whether to proceed with audit, including decisions regarding issues to target in the audit

• Internal review and quality control processes, including central committee review if such a committee is used

• Prepare final risk assessment report

5.3 Preparing a risk assessment report

137. It is important that a risk review process be conducted in a regular and systematic manner. When a decision is made that a particular situation raises transfer pricing risk that warrants either a thorough or targeted audit, the reasons for reaching those conclusions should be reflected in a written assessment report.

138. The risk assessment report should contain a summary of the work undertaken in the risk assessment process. The report should also set out very clearly the risk indications that have been identified and the reasons for the conclusion that an audit is required. In particular, the report should indicate which one or more of the risk indications described in the tables on pages 21-22 give rise to the conclusion that the matter should be audited in detail.

139. In addition to recording the conclusions of the risk assessment, a risk assessment report should contain an audit plan. It should reflect with specificity the issues that have been noted as requiring particular inquiry.

5.4 Use of specialists

140. Specialists have a part to play in effective risk assessment process. Many tax administrations use general tax auditors or tax inspectors to undertake the initial risk assessment, but a number of them also involve specialists to help make the finely balanced judgements required in identifying and assessing the risk.

141. For example, some tax administrations develop a cadre of sectoral experts who have a good understanding of key sectors, such as banking or pharmaceutical industry. They require the case team that is reviewing a potential transfer pricing risk for audit to consider seeking input from the relevant specialists, including, for example, economists, trade sector advisers and corporate finance specialists.
142. The risk assessment can guide decisions regarding the conduct of an audit. Whether to conduct a transfer pricing audit independently from other tax audits or as a part of an overall tax audit is an important decision in making an audit plan. Some countries routinely use specialised transfer pricing auditors and do separate audits of transfer pricing issues. Others conduct general audits, involve fewer transfer pricing specialists, but include transfer pricing issues in the general income tax audit. In cases where transfer pricing risk is identified, the tax administration may assign transfer pricing specialists to the audit team where the risk is quite high. It is important to allow the risk assessment to guide decisions regarding assignment of resources and the structure and design of the actual audit.
6. BUILDING PRODUCTIVE RELATIONSHIPS WITH TAXPAYERS – THE ENHANCED ENGAGEMENT APPROACH

6.1 Objectives and rationale

143. Because of the degree of judgement involved in establishing appropriate arm’s length results, and the cost implications of a transfer pricing examination for both the taxpayer and tax administration, it may well be sensible to have discussions between the taxpayer and the tax administration about transfer pricing issues before a tax return is made, or even before the transactions take place. Such discussions provide earlier opportunities for taxpayers and tax administrations to consider issues and get comfortable with transfer pricing positions at a very early point in time.

144. With that objective in mind, several countries have adopted programmes intended to increase the amount of real-time engagement with taxpayers on transfer pricing issues. The programmes of several such countries for early engagement with taxpayers are summarised in the following section.

145. An important advantage perceived by taxpayers and tax administrations that have participated in such arrangements is the ability to resolve potential transfer pricing disputes at a point in time when relevant information and key employees are available.

146. Some countries have also experienced a reduction in the time taken to review an issue and a reduction in the overall number of disputes. Some believe that taxpayers are more inclined to compromise in transfer pricing controversies when the discussions take place before tax returns are filed and financial statement positions are solidified.

147. An important question to be addressed where a government seeks to establish this sort of cooperative relationship with taxpayers is whether tax administrations should share their risk assessments with the affected taxpayer before committing themselves to an in depth audit of all the issues they have identified. Business generally suggests that sharing the risk assessment would provide an opportunity to explain any misunderstandings, or to clarify aspects of the risk assessment that were based on partial information. Some tax administrations, though certainly not all, have chosen to follow a policy of sharing risk assessments with the affected taxpayer.

148. Business would welcome the systematic sharing of transfer pricing risk assessments, even in cases that are not selected for audit, as this would help them to allocate their own resources to the areas of most concern. It would encourage business to comply with the rules before filing returns.

6.2 Country examples

6.2.1 Netherlands

149. The Netherlands’ Tax and Customs administration (“NTCA”) has implemented compliance risk management to achieve its goal of influencing taxpayer behaviour to maintain and/or improve compliance. Compliance risk management is defined by the European Commission as a systematic process in which a tax administration makes substantiated choices on which interventions could be used to effectively stimulate compliance and prevent non-compliance, based on the knowledge of the behaviour of all taxpayers and related to the available capacity.

150. In the variety of tools and approaches which constitute compliance risk management, Horizontal Monitoring is one of the key approaches of the NTCA. Horizontal Monitoring started in 2005 as a pilot
project for the Large Businesses Segment and it is now widely applied. For this segment Horizontal Monitoring constitutes an individual approach which is based on three key principles: mutual, justified trust, transparency and understanding. These principles are put down in an individual compliance agreement. The following ground rules apply:

- significant risks are disclosed by the company on a real time basis
- the company submits facts and gives its view on the tax consequences
- the tax administration in return quickly provides its view on the tax consequences

151. In short, the approach can be described as “certainty in exchange for transparency”. Early disclosure of significant tax risks is of importance; businesses are expected to have a tax control framework in place to ensure that they are ‘in control’ and to ensure timely discovery of these risks. From the NTCA’s perspective ‘understanding the business’ and the ‘commercial awareness’ are of importance; the NTCA will be better equipped to take a view on the tax consequences. This approach ensures early certainty for both the taxpayer and the NTCA; in fact a “green lane” is created for tax returns under the Horizontal Monitoring programme.

152. In preparing for an individual compliance agreement the NTCA distinguishes a number of phases; one of the most important ones is resolution of pending tax issues.

153. Horizontal Monitoring is not rule-based but principle-based. It is important to note that compliance agreements are not about putting aside law, tax policy and jurisprudence and they do not create additional rights or obligations for the covenant partner. A compliance agreement is no more than 1.5 pages. Compliance agreements cover all taxes; they also include tax collection.

154. The Horizontal Monitoring approach was recently evaluated by an independent Committee established by Government; the Committee endorsed Horizontal Monitoring, especially for the Large Business Segment.

6.2.2 United Kingdom

155. Legal certainty about the tax treatment of the transfer pricing aspects of transactions prior to the submission of the relevant tax return is only available under the statutory Advance Pricing Agreement process.

156. However, HMRC also operate a “real time working” procedure for the discussion with businesses of the likely tax position regarding specific transactions prior to submission of the relevant tax return. Under this procedure an indication may be given, expressed in terms of the level of risk, of how HMRC might see the tax risk relating to particular transactions, without leaving any inference that any particular price for goods or services used for calculating profits in a tax return will automatically be considered to be an appropriate transfer price.

157. HMRC’s guidance on real-time working of transfer pricing issues can be found in its International Manual at INTM480540 et seq. [http://www.hmrc.gov.uk/manuals/intmanual/intm480540.htm](http://www.hmrc.gov.uk/manuals/intmanual/intm480540.htm)

158. HMRC’s Governance requirements for enquiries into transfer pricing issues (upon which guidance may be found at INTM481000 et seq: [http://www.hmrc.gov.uk/manuals/intmanual/INTM481000.htm](http://www.hmrc.gov.uk/manuals/intmanual/INTM481000.htm)) apply equally to real time working discussions.
6.2.3 United States

6.2.3.1 CAP Background

159. In March 2005, the IRS launched a pilot to assess the viability of an alternative approach to large corporate tax administration. This approach – known as the “Compliance Assurance Program” (“CAP”) – was structured to leverage new, non-tax corporate governance and financial reporting requirements brought about by the Sarbanes-Oxley Act of 2003.

160. Traditional post-filing examinations for large corporations tend to be time-consuming and resource-intensive for both taxpayers and the IRS. These exams require a retrospective accounting of a taxpayer’s prior business decisions, completed transactions and tax positions. Typical post-file examinations commence months or years after the tax return is filed and, once underway, can take years to complete. Additionally, the further back in time an exam is focused, the greater the administrative and financial burdens on the taxpayer and the IRS. In particular, when issues under examination remain unresolved for extended periods, taxpayers may be obliged to maintain tax reserves on their books in anticipation of an exam outcome. In some cases, this can affect a corporation’s financial statements, reporting, and share price.

6.2.3.2 How CAP Works

161. Under CAP, a taxpayer works cooperatively with IRS revenue agents in a contemporaneous, pre-filing environment to resolve issues of potential controversy and to determine the appropriate tax treatment of all events and items that could have a material effect on the taxpayer’s liability. In exchange for increased cooperation and transparency, the taxpayer can achieve tax certainty sooner – and with less administrative burden – than has been possible through conventional post-file examinations. CAP requires extensive communication and cooperation between the IRS and the participating taxpayer.

162. Early in the CAP cycle, the taxpayer enters into a Memorandum of Understanding (MOU) with the IRS. The MOU outlines the roles and responsibilities for both parties, and describes the process that will be followed, including communication and disclosure responsibilities.

163. Once the MOU is signed, the IRS works with the taxpayer during the CAP year to identify and to attempt to resolve potential issues relating to the tax return for that year. An account coordinator (AC) is assigned to the CAP taxpayer and is responsible for managing the CAP cycle. The AC conducts a taxpayer risk analysis using taxpayer-provided data and information collected from a variety of third-party sources. As the year progresses, the AC reviews the taxpayer’s significant business transactions in real time.

164. The CAP taxpayer is required to disclose all transactional events and items that could have a material effect on its federal income tax liability, and all compliance-related matters. A transaction or item that has a “material effect” on the taxpayer’s U.S. federal income tax liability includes but is not limited to those items for which the taxpayer will or would be required to maintain reserves for purposes of any financial statement for the CAP year or any period subsequent to the CAP year. Special disclosure certifications are required incident to filing the return for the CAP year.

165. Transparency and communication are essential elements of the CAP approach and are emphasized in the MOU. The taxpayer enters CAP with the expectation of having to provide pertinent

---


3 SEC filings, Taxpayer annual reports, news stories and accounts, etc.
information to the AC relating to the issues and completed transactions under review. The expectation is that the AC will actively partner and communicate with the taxpayer, efficiently manage and coordinate information data requests, and keep the review process moving forward to a completion.

6.2.3.3 Outcomes Resulting from the CAP Process

At the conclusion of the CAP pre-file period, the AC analyzes the agreements reached with the taxpayer on the various issues reviewed. If the taxpayer has fully complied with the terms of the MOU and if all identified issues have been resolved, the IRS will provide written confirmation that it will accept the taxpayer’s return, if it is filed consistent with the agreed upon treatment of the issues, and if no other material items are identified during the post-file examination. This type of written confirmation is known as a “Full Acceptance Letter.” If, on the other hand, the taxpayer has fully complied with the terms of the MOU, but the IRS and the taxpayer cannot resolve all identified issues prior to filing the tax return, the IRS issues a “Partial Acceptance Letter.” With this result, the Service continues the examination of unresolved issues in the post-file examination.

Once the taxpayer files the return, the AC and the taxpayer will participate in a joint post-file examination to verify that all resolved issues were reported as agreed. In addition, they will try to settle any unresolved issues prior to the filing of the tax return. If the post-file examination reveals that the return is consistent with the agreed upon treatment of the issues, and no other material items are identified that were not disclosed prior to the filing of the tax return, the AC will issue a “No Change Letter.” This action formally concludes the examination of the taxpayer's books.

6.2.3.4 Pilot Made Permanent

In March 2011, following six years of success with the program, the IRS made the CAP pilot permanent. A “pre-CAP” program is available to assist taxpayers in preparing for admission to CAP. In addition, the IRS has established a “CAP Maintenance” program for taxpayers that have demonstrated eligibility for a reduced scope and depth CAP review.
ANNEX 1
INFORMATION RETURN FORMS

Canada:
Form T106: Information return of non-arm’s length transactions with non-residents
Form T1134-B: Information return relating to controlled foreign affiliates

India:
Form No.3 CEB: Report from an accountant to be furnished under section 92E relating to international transaction(s)

Norway:
Form RF-1123: Controlled transactions and accounts

United States:
Form 5471: Information return of U.S. persons with respect to certain foreign corporations
Form 5471 – Schedule J: Accumulated earnings and profits of controlled foreign corporation
Form 5471 – Schedule M: Transactions between controlled foreign corporation and shareholders or other related persons
Form 5472: Information return of a 25% foreign-owned U.S. corporation or a foreign corporation engaged in a U.S. trade or business
ANNEX 2
SUPPLEMENTARY QUESTIONNAIRES

Belgium:
Questionnaire

Malaysia:
Form MNE: Information on cross border transactions

New Zealand:
Transfer pricing questionnaire: Foreign-owned multinationals
Transfer pricing questionnaire: New Zealand owned multinationals
Transfer pricing questionnaire: New Zealand branches

South Africa:
Transfer pricing questionnaire: Foreign-owned multinational groups
Transfer pricing questionnaire: South African-owned multinational groups
ANNEX 3

PROVISIONS TO REQUIRE INFORMATION HELD IN FOREIGN ASSOCIATED ENTERPRISES

Canada:
Income Tax Act, Section 231.6

Ghana:
Internal Revenue Act, 2000 (ACT, 592), Section 125

United States:
Internal Revenue Code, Section 6038A
ANNEX 4

PROVISIONS TO OBTAIN INFORMATION RELATING TO DOMESTIC POTENTIALLY COMPARABLE BUSINESSES

Canada:
Income Tax Act, Section 231.1
Transfer Pricing Memorandum, TPM-04

Ghana:
Internal Revenue Act, 2000 (ACT, 592), Section 125

India:
Income Tax Act, 1961, Section 131

Malaysia:
Income Tax Act 1967, Section 81