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Transfer Pricing Unit
Organisation for Economic Co-operation and Development

By email: transferpricing@oecd.org

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Dear Sirs

Draft Handbook on Transfer Pricing Risk Assessment

Thank you for the opportunity to comment on the Draft Handbook on Transfer Pricing Risk Assessment (the "Handbook").

The OECD's objective to assist tax authorities with maximising the efficient use of their limited resources when reviewing the transfer pricing of multinational organisations is important. There is also an opportunity for businesses: better risk assessment procedures by tax authorities can reduce time and associated compliance costs spent on audits where there is little likelihood of a transfer pricing adjustment that is sustainable under a double tax treaty.

The bilateral nature of transfer pricing means there is also considerable benefit in having standardised advice such that tax authorities on two sides of a transaction approach the rating of risk in the same way. This benefit extends to the information that is requested and considered by tax authorities in order to determine whether or not a transfer pricing audit should be opened. The principles of the Handbook could also reduce incidences of double taxation requiring resolution, if available, under double tax treaties.

Detailed comments on the specific sections of the draft Handbook are included in the attached appendix.

Statement of principles

In order to gain maximum effectiveness, the Handbook should contain an overarching statement of the principle risk factors of transfer pricing as they affect an entity. Factors to consider would include:

- The entity's related parties;
- What transactions have been undertaken with the related parties, including
    i. The types of transactions; and
    ii. The volume and value of such transactions;
- How these transactions have been priced; and

- Why the pricing is arm's length.

Focussing the risk review in this way will speed up the process and enable tax authorities to focus their efforts. Using these headings, taxpayers could be categorised, for example:

- Unconnected enterprises (with no transfer pricing risk);
- Only connected to high-tax countries (less likelihood of profits being diverted);
- Simple transactions at low value (little financial risk); etc.

Lough Erne Declaration and Action 13 of the BEPS Action Plan

There is an obvious link between the risk assessment process for tax authorities and adequate information being provided by taxpayers at a suitably early stage. We note that further work is being undertaken in this area as part of Action 13 of the Base Erosion and Profit Shifting (BEPS) Action Plan, following the June Lough Erne Declaration by the G8. We have not provided detailed comments in this letter on Action 13, but an initial observation is that the provision of information should focus on a tax authority's ability to assess the risk of base erosion and profit shifting, or lack of risk, in relation to transfer pricing. The key is to ensure that the information provided is relevant, clearly targeted and most importantly brief, so that tax authorities can focus minimum resources on reviewing papers. It is also essential that a global standard template is agreed to ensure that tax authorities have access to the same information, whilst keeping the compliance burden on businesses proportionate to tax authorities' objectives. A significant aspect will be to ensure confidentiality of information and also to ensure that it is not used for inappropriate enquiries.

Base erosion

Notwithstanding the comments above, the Handbook will also deal with situations where transfer pricing risk arises but where there is not profit shifting (eg cases of error or where a tax authority takes a different view of the arm's length price). The Handbook includes several references to base erosion; a phrase which can be misleading in this context. All payments, whether to related or unrelated parties, reduce the taxable profits of an enterprise. Many payments relate to situations where the capital, function or asset is overseas and it is being used by the enterprise in the course of its business. The question is therefore whether the pricing for the payment is arm's length based on the facts and circumstances. Perhaps a reference to 'unjustified' payments in the Handbook would be more appropriate.

Two-stage process

There is some inconsistency in the Handbook as to whether the risk assessment should be based upon the size of transactions and the potential for the price to be wrong as a single or two-stage process. One would normally expect this to be a two-stage process: considering the risk of error and then the size of the transaction, such that only cases where the risk and size are both of sufficient magnitude warrant selection for audit. This approach is consistent with the wording of section 3.1.4; however, the draft Handbook does not generally make clear that this is the approach to be taken.

Macroeconomic risk factors

The draft is focussed upon 'internal' risk factors within a multinational, and we agree these are the most important factors to be considered in assessing risk. However, it is also appropriate for reference to be made to the macroeconomic circumstances under which the enterprise is operating (or was operating during the period under consideration). In particular, macroeconomic events in an industry or local market could have a significant impact on returns due at arm's length which should be taken into account in the assessment of risk. (This would include but is not limited to situations where losses are incurred).

Communication between tax authorities and taxpayers

It would be helpful if greater emphasis is placed, throughout the document, on the need for efficient and timely communication between tax authorities and multinationals. Many hours of work reviewing documents could be saved by talking to the people who know the business and its transfer pricing in depth. In addition, perceived anomalies may be readily explicable by those responsible for the transfer pricing and tax compliance, which could prevent needless audits.

If you wish to discuss any of the points raised in this letter, please do not hesitate to contact either me (jhenshall@deloitte.co.uk) or Alison Lobb (alobb@deloitte.co.uk).

Yours faithfully

John Henshall
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Appendix

Detailed comments (references are to numbered paragraphs in the Handbook)

3. An explicit principle of transfer pricing risk assessments and audits should be that where tax authorities are of the opinion that an adjustment could not be sustained through a mutual agreement procedure ('MAP'), no such adjustment should be proposed by the tax authority. The wording of paragraph 3 could be interpreted to indicate that a lower standard of proof is required where there is no recourse to MAP.

13. The second bullet point in this paragraph should be expanded to ensure that it takes into account the need to consider the size of the transactions and therefore the tax at stake. For example, it could be rewritten as:

"Help the tax administration to determine whether the level of risk is high and the size of the transaction(s) are such that there is considerable tax at stake in order to inform a decision as to whether a transfer pricing audit should be commenced:"

15. To make it clear that the risk assessment is not a substitute for an audit, new paragraph 15A should be inserted as follows:

"The level of resources committed at the risk assessment stage will only be sufficient to indicate that the transfer pricing risk is such that detailed enquiry should be undertaken, or would be unlikely to provide sufficient return to the tax authority to justify the resource commitment of an in-depth enquiry. The risk assessment will not guarantee that a transfer pricing adjustment is, or is not, needed; that question can only be answered after the conclusion of a detailed audit."

24. The second sentence of paragraph 24 relates transfer pricing risk directly proportionately to the size of the cross-border transactions between related entities. However, paragraphs 22 and 23 address situations where transactions have taken place which do not result in anything being booked to the company's accounts. This paragraph should be reworded so that the materiality of inter-group transactions is seen as a separate possible indicator of risk, rather than a direct link.

30. An additional phrase should be added to paragraph 30 – underlined below:

"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 <u>to ensure all payments are warranted and that amounts are arm's length in value."</u>

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34. The first sentence of paragraph 34 should set out that "the risk assessment process does not end with a determination that there is potential material transfer pricing risk". This is to make clear that the risk assessment process will only identify the potential for misstatements, not actual misstatements.

37. Further to the general comment above, the use of the phrase *"erode a country's tax base"* is inappropriate in this context. All tax deductible payments to overseas entities, related or unrelated, erode a country's tax base. This is important in the bilateral context of transfer pricing, where there is also a need from the other country's perspective to ensure that services, royalties etc are charged for at arm's length.

41. The words "... or absent" should be added to the end of the paragraph to highlight the fact that there is also a risk of failure to make certain payments. The final sentence of the paragraph would then read:

"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 or absent".

43. At paragraph 43, the Handbook discusses risks arising from large or complex one-time transactions. Business restructuring or other one-off transactions do have the potential to alter the transfer pricing relationships between group members. However, the paragraph goes on to say that "such transactions **should generally** be viewed as requiring additional scrutiny". This sentence would be better if it read "such transactions **could potentially** require additional scrutiny". The word "generally" in this sentence could create significantly more work for both tax authorities and taxpayers when, having regard to all the circumstances, a full review may not be necessary in all cases.

45. Behaviour of the taxpayer is an important factor to be considered when assessing risk of any kind. However, paragraph 45 needs further consideration - the centralisation of accounting functions and tax compliance (which may or not be in the parent company) are not, of themselves, indicators of higher risk. Centralisation of transfer pricing compliance, in particular, can be a logical cost control measure that also allows a multinational to take a global view and prevents 'gaps' in the arm's length pricing of transactions. This paragraph should emphasise that the risk arises from taxpayers paying insufficient attention to compliance and lacking fundamental information; and that this is not the same as the question of where the transfer pricing specialist is based, nor where the documentation is maintained (if it's not in the offices of the entity under review). Of course, adequate documentation and records must be capable of being provided to the relevant tax authority upon legitimate request.

49. The idea that the tax payable by the associated entity is not directly relevant is not consistent with the guidance expressed in paragraphs 40 and 42 which state that consideration must be given to the identity and tax attributes of related parties which are party to the transactions with the entity under review. Furthermore, risk indicators discussed in paragraphs 67 and 68 also refer to the identity and tax attributes of other related parties transacting with the entity which is the subject of the review. To have maximum value, it is important that the guidance is as clear and unambiguous as possible.

66-68. The factors identified in these paragraphs suggest a 'greater risk' of mispricing.

74. Conversely, there may also be a risk where payments of the type identified in this paragraph are not made for the tax authority of the would-be recipient.

75. Paragraph 75 focusses on the potential risk of income being channelled to a company under the guise of marketing or procurement related payments in excess of what could be justified on an arm's length basis. However, under modern commercial practices, there is an acknowledged move towards centralisation of regional sourcing companies and regional logistics. Such changes are made for commercial purposes and to increase groups' efficiencies. The wording of this paragraph should reflect the importance of considering this risk factor alongside other factors and to recognise commercial reasons (and arm's length pricing based on the activities undertaken) for groups providing services centrally.

78. Where intangibles are bundled they may need to be valued in aggregate, but this must accord with the current position of the OECD's Transfer Pricing Guidelines at paragraphs 3.9 to 3.12 that the assets comprising the bundle should be separated and individually priced *unless* they are 'so closely linked or continuous'. Any advice that could be seen as contradictory could cause confusion and adversely impact the authority of the Handbook. It may be appropriate to revisit this point, and paragraphs 3.9 to 3.12 of the Guidelines, to both ensure consistency and to make explicit reference to what happens at arm's length. For example, a franchise may include many elements of intangible property but at arm's length they are not unbundled to be separately valued and charged.

80. A further consideration should also be the projected future use of the intangible. The valuation of an intangible should not be based solely on current use.

88. Bullet point 4 is unrealistic – how could an individual tax authority be sure of this?

90. When considering information available to be used by tax authorities in performing risk reviews, the Handbook should note that 'secret' information available to the tax authorities from other taxpayers but not in the public domain can be used to inform a risk review but cannot be used in an audit, should one be considered appropriate (reference paragraph 3.36 of the Transfer Pricing Guidelines).

98. This paragraph discusses full transfer pricing documentation, and not the information that should be requested for risk assessment purposes. As discussed in the general comments above, there is a clear link here between risk assessment and the work being done on transfer pricing documentation under Action 13 of the Base Erosion and Profit Shifting Action Plan as well as the transfer pricing simplification project. It makes sense to link this part of the Handbook to the outcome of that work rather than list here information that is in all likelihood too burdensome for the purposes of risk assessment (and which tax authorities will not have the resources to process effectively). A list here that is wider than the outcome of the Action 13 work could be counter-productive to providing straightforward guidance and promotion of the 'common template' concept. From a business perspective, the common template, standardised approach is key to minimising unnecessary transfer pricing compliance burdens; whilst at the same time providing tax authorities with appropriate, relevant and targeted information for risk assessment.

131. The Handbook recommends that tax authorities review the effective tax rate for significant variations between the effective tax rate and the nominal rates to which the taxpayer should be subject. Differences between the effective tax rate in the group financial statements and the consolidated nominal rate may be explained in notes to financial statements (under common

GAAP such as IFRS, US GAAP and many others) and may be due to a number of factors, of which transfer pricing is just one. In the absence of such a reconciliation in the accounts, and unless the company being looked at is very simple, it will be difficult to obtain a meaningful understanding of transfer pricing risk from a comparison of effective and nominal tax rates.

136. Perhaps the most important step in the risk assessment process is discussions with the taxpayer. Conducting a risk assessment process without discussion may increase the likelihood of wasted resources on both sides. This is particularly relevant in relation to concerns about specific items. An example might be where there is a concern that payments are being made to a jurisdiction where the effective tax rate is too low, which could be explained by large depreciation allowances in the other jurisdiction. Without discussing this concern with the taxpayer, time might be wasted, despite the tax authorities having followed recommended procedures.

This point is raised at paragraph 143, where it is recommended that tax authorities and tax payers should consider discussing transfer pricing issues in advance of filing tax returns or, in some circumstances, prior to transactions actually taking place. Greater emphasis should be placed on such communication between taxpayers and tax authorities throughout the Handbook.