TAX EXECUTIVES INSTITUTE, INC.

11 September 2013

Steering Committee of the OECD Global
Forum on Transfer Pricing
Organisation for Economic Co-Operation and Development
Paris, France

Via email: TransferPricing@oecd.org

RE: Tax Executives Institute Comments on the OECD's Draft Handbook on Transfer Pricing Risk Assessment

To Whom It May Concern:

In November 2011, the Steering Committee of the OECD Global Forum on Transfer Pricing launched a project on transfer pricing risk assessment with the objective of producing a practical handbook to provide clear and detailed steps countries may take to assess transfer pricing risk presented by taxpayers. As a result of this initiative, the OECD released for public consultation a Draft Handbook on Transfer Pricing Risk Assessment (Draft Handbook) on 30 April 2013. The OECD requested comments from interested parties on the Draft Handbook by 13 September 2013. On behalf of Tax Executives Institute, Inc., I am pleased to provide the following comments on the Draft Handbook.

I. TEI Background

Tax Executives Institute (TEI) was founded in 1944 to serve the needs of business tax professionals. Today, the organisation has 55 chapters in Europe, North America, and Asia. As the preeminent association of in-house tax professionals worldwide, TEI has a significant interest in promoting tax policy, as well as the fair and efficient administration of the tax laws, at all levels of government. Our 7,000 members represent 3,000 of the largest companies in Europe, the United States, Canada, and Asia.

II. General Comments

TEI commends the efforts of the OECD's Committee on Fiscal Affairs to provide much needed clarity to the taxation of complex international business transactions, especially transfer pricing issues. Overall, the Draft Handbook is a workable document that largely points in the right direction. TEI shares the OECD's concern that double-taxation of business profits hinders economic progress and growth, and applauds the OECD for its work in this area.

The Draft Handbook rightly focuses on risk assessment. As a threshold matter we note that large, multi-national enterprises (MNEs) – especially those that are publicly traded – create, maintain, and adhere to robust transfer pricing compliance and documentation policies as part of their internal controls. Thus, the transfer prices of MNEs are based upon the arm's length principle and the underlying economics of their business endeavors. We urge the OECD to clarify that an understanding of the overall business enterprise and its risk controls is critical to a proper understanding of the enterprise's transfer pricing analysis when jurisdictions conduct a risk assessment of an enterprise affiliate.

Increased Cooperation between Tax Administrations and Taxpayers

The increasingly global business models adopted by MNEs along with the pace of technological change have led to an increase in tax controversy, both between tax authorities and taxpayers as well as between taxing jurisdictions. For example, advances in the so-called "digital economy" and other areas have led to increased controversy in the taxation of international commerce. OECD members often do not agree on "where" to tax controlled transactions among MNE members in such circumstances; hence tax authorities and taxpayers often pick the rule that produces the best result. A simplified set of rules in this area would reduce controversy and spur economic growth. In addition, the international tax landscape is rife with multi-lateral tax controversies. While disputes generally arise in the taxpayer versus tax administrator setting, the friction often spills over into country versus country disputes, exacerbating the conflict and increasing the many instances of double-taxation.

In our view, the OECD's effort should be directed toward producing equitable and administrable guidelines promoting cooperation and an enhanced relationship between taxpayers and tax authorities rather than providing tax administrators with yet another tool to address transactions deemed objectionable. A common set of rules equitably applied by all countries and taxpayers would benefit all parties. We are thus surprised that the OECD limited the Draft Handbook's discussion of enhanced engagement[1] to current practices and instead of exploring what governments can do to spur taxpayer cooperation.

In this regard, any OECD guidelines for "risk assessment" of transfer pricing should take into account the behavior of tax administrators as well as taxpayers. That is, "cooperation" should be mutual between taxpayers and tax authorities. Where a taxpayer views tax authorities as aggressive, unfair, or biased, the taxpayer may not be willing to be open and

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1 *See* Draft Handbook, Section 6, pages 33-36.

transparent for fear that the tax administrator may issue an assessment even though the taxpayer has timely complied with its tax obligations. Moreover, there is unfortunately no level playing field across all taxing jurisdictions as only a limited number of countries effectively respect most generally accepted tax standards such as the arm's length principle.

The Draft Handbook's Approach to the Risk Assessment Process

Overall, the Draft Handbook places too much emphasis on "risk increasing" factors with little balancing discussion of "risk decreasing" factors or practices that taxpayers may employ to mitigate risks, enhance compliance, or achieve the market price equivalence the arm's-length principle promotes. That is, the Draft Handbook seemingly encourages tax authorities to employ a one-way ratchet that only increases scrutiny of controlled taxpayer transactions rather than providing a true "risk assessment" that would increase the effectiveness and efficiency of transfer pricing audits by decreasing focus on taxpayers that exhibit risk decreasing factors or behaviors. For example, the Draft Handbook often notes that transactions with low tax countries is a risk increasing factor, but rarely notes that transactions with high tax (or nearly tax equivalent rate) countries should be a risk-decreasing factor. We suggest the document balance its discussion of this particular risk factor in addition to placing more emphasis on risk decreasing factors.

Even if this imbalance is corrected, we note taxpayers assessed as "high risk" by tax authorities may nevertheless experience a biased audit. That is, auditors assigned to high risk taxpayers are often under informal pressure to find at least some adjustments to justify the dedication of scarce audit resources to the taxpayer. Where the attention is unfounded, the increased scrutiny will result in an unnecessary waste of time and resources for both the taxpayer and tax administrators. Indeed, categorisation of a taxpayer as high risk may be counterproductive to a cooperative audit relationship if the auditor views the taxpayer's return position as a "first offer" in a protracted negotiation of the taxpayer's liability rather than a principled application of the arm's length principle. Thus, authorities should caution auditors that a high risk profile does not necessarily indicate that the taxpayer has engaged in unprincipled or aggressive transfer pricing practices.

The Draft Handbook is also intended to assist countries in identifying and assessing transfer pricing risk to select the most appropriate taxpayers and transactions for audit. The risk assessment approach should then result in a more efficient and effective allocation of audit resources and a more focused and shorter audit. Yet, the Draft Handbook seems to consider everything to be a risk factor. This undermines utility of the document since it encourages tax authorities to focus on every risk factor instead of distinguishing between the more and less important risk factors in a given case.

Finally, we are surprised the Draft Handbook does not leverage the OECD's recent work in the transfer pricing area. Indeed, it does not refer to new Chapters 1-3 and 9 of the OECD's

Transfer Pricing Guidelines or to its recent work on safe harbors. For example, there are many instances where use of the transactional net margin method would simplify and provide a more objective transfer pricing analysis, including with respect to intangibles. Thus, the document should emphasise that because the arm's length principle is the standard for setting transfer prices, the taxpayer may use the most appropriate transfer pricing method. This implies that tax authorities must understand the legal and economic background of a taxpayer's business to properly assess the correctness of the taxpayer's transfer prices.

III. Recommended Additions to the Draft Handbook

TEI recommends that the OECD include the following in the Draft Handbook:

- A separate chapter devoted to companies that use a "Principal" business model to demystify its use by MNEs. A Principal business model (or Central Entrepreneur) is a centralised business model whereby a MNE concentrates most of its financial, intangibles, strategic, supply chain, ERP platform and marketing capabilities in one legal entity to service a regional or even broader market. Because most of the risks are borne by the Principal, the intercompany relationship between the Principal and its associated enterprises is usually organised under contract manufacturing and limited risk distributor structures. The use of a Principal model, if correctly applied and documented, can dramatically simplify transfer pricing documentation and benchmarks (based on one-sided transfer pricing methodologies), as well as provide transparency for tax authorities.

- A paragraph devoted to the requirement that tax authorities respect and safeguard the confidentiality of sensitive business information collected during a transfer pricing audit. Disclosure of such information can substantially affect the underlying business of an MNE and place them at a significant competitive disadvantage. This is of particular concern when tax administrations ask for information regarding strategic, operational and process information.

- A paragraph should be developed discussing the use of comparables, referring to Chapters 1-3 of the OECD Transfer Pricing Guidelines. In addition, the Draft Handbook should enable taxpayers to use regional or worldwide comparables where local country comparables are unavailable. Finally, where reliable comparables are not available, taxpayers should be permitted to use economic studies to demonstrate compliance with the arm's length principle.

IV. Comments on Specific Paragraphs of the Draft Handbook

Handbook Introduction (§ 1); *Is there an indication of transfer pricing risk?* (§ 2.2)

Paragraphs 7 & 29: Paragraph 7 begins "Many taxpayers seek to comply with the applicable transfer pricing rules." We recommend that "many" be changed to "most" or "the vast majority" to reflect the tax risk controls instituted by taxpayers as well as the importance taxpayers (especially MNEs) place on tax compliance. While seemingly insignificant, the use of the indefinite quantity "many" implies that "many" taxpayers also do not seek to comply. We disagree and suggest that the word reflects the current tense environment between taxpayers and tax authorities. Similarly, paragraph 29 states that related party payments "often . . . will reflect arm's length compensation for legitimate transactions." Here the use of "often" instead of, for example, "in most cases," also reflects the current climate, and may lead tax authorities who use the Draft Handbook to suspect that most taxpayers do not comply with the arm's length principle.

Paragraph 13: A bullet should be added to this paragraph noting that a proper risk assessment will "Incentivise taxpayers to be compliant and cooperative through a lighter touch approach in transfer pricing audits of low-risk taxpayers." While countries with aggressive tax authorities can always threaten to impose penalties or other sanctions to promote compliance, taxpayers are less likely to be cooperative in a hostile audit environment, resulting in a waste of scarce audit resources on both sides.

Are there material controlled transactions? (§ 2.1)

Paragraph 23: This paragraph implies that transfer pricing risks are heightened where an MNE operates through branches or permanent establishments in a country, noting that a "closer than normal review might be appropriate" in such circumstances. TEI submits it would be helpful to users of the Draft Handbook as well as MNEs if the OECD could explain why it believes this to be the case.

Paragraph 24: The paragraph provides that 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." This is equivalent to saying that a taxpayer purchasing services or goods is more able to manipulate the transfer pricing rules than the taxpayer that provides the services or goods to the first taxpayer. TEI considers these examples to be a single transaction that is subject to equal risk or error by both sides. We therefore suggest the OECD further explain its reasoning behind the above statement.

Risk Factors (§ 3.1)

Paragraph 45: This paragraph uses the term "tax shelters," which is primarily a legal concept used in the United States and may leave non-U.S. readers confused as to its meaning. Indeed, that term has never been defined directly by the United States. Certain transactions that exhibit hallmarks or indicators of "tax shelters" must be disclosed, but the transactions themselves are not by reason of the disclosure deemed "tax shelters." Thus, the OECD should strike the term from the paragraph, leaving "aggressive tax strategies," or replace it with other, more broadly applicable wording.

Paragraph 47: This paragraph notes correctly that poor compliance combined with a high volume of related party transactions should result in an increase in the taxpayer's risk assessment. However, the Draft Handbook does not state the obverse: that consistent, high-quality documentation should decrease a taxpayer's risk assessment. While the paragraph references "consistent transfer pricing policies" as a factor that would decrease risk assessment, that phrase is not the same as transfer pricing documentation. The Draft Handbook should specifically note that high-quality documentation should decrease the risk assessment.

That said, the Draft Handbook should not impose stringent documentation requirements or disproportional documentation burdens for minor transactions. Taxpayers are every bit as resource-constrained as tax authorities.

Risk indicators observed from related party transactions (§ 3.2.1)

Paragraph 55: The draft paragraph urges tax authorities to use experience and knowledge from "past audits or advance pricing agreements" along with contemporaneous documentation that contains comparisons with identified comparables to provide a starting point for comparing a taxpayer's results with industry standards. The implication that information gleaned in audits or advance pricing arrangements of one taxpayer should be used to evaluate the compliance of other taxpayers could be misconstrued as encouraging the use of secret comparables. We urge the OECD to reject the use of secret comparables since taxpayers will not have access to such information in setting their transfer prices. As important, the OECD should support data confidentiality, not undermine it as it appears to do in this paragraph. TEI has grave concerns that non-public financial and other data may be disclosed or used inappropriately in such circumstances. We thus urge the OECD to encourage its members to prohibit sharing transfer-pricing information across the files of multiple taxpayers.

Paragraph 63: This paragraph states "Some business activities might be expected to make profits from the outset" and then cites examples such as commercial contract research and technical assistance services. TEI recommends the OECD modify this paragraph to note that before a tax authority asserts a position that an activity should "make profits from the outset" it should investigate the risk profile of the business activity (*e.g.*, cost center, revenue center, profit center) and its relationship to the overall business model of the MNE.

Paragraph 65: We recommend that the third sentence, "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" be revised to read ". . . but the local entity's profits are low *and risks assumed are high* . . . ." Under the arm's length principle a local entity that has assumed little risk should earn a lower return than an entity that has assumed greater risk.

Intra-group service transactions (§ 3.2.1.3)

Paragraph 70: This paragraph asserts that "Intra-group service transactions may be one of the most frequently occurring transfer pricing issues." A likely reason for this is that, while most such transactions are structured at arm's length, they are easy targets for tax authorities because of the difficulty of documenting the benefits for the taxpayer and because the services received are often performed in high cost countries and thus result in a relatively high transfer price. This encourages tax authorities in the service recipient jurisdiction to make adjustments. To foster taxpayer collaboration, the OECD should discourage its members from making adjustments merely because they are easy or because of taxpayer challenges in documenting their transfer prices (*e.g.*, because of the lack of comparables).

As to the fact that these services are often performed in high cost countries, one possible solution may be for the OECD to introduce a rule or rebuttable presumption for these charges. For example, tax authorities could accept that an intra-group service transaction was necessary for the receiving affiliate and properly compensated if a taxpayer fully discloses its cost base and allocation mechanism while applying a cost plus charge for the transaction. The primary point, however, is that as long as the cost has been properly identified and allocated among all the participants in the group, the fact that such services are performed in a high cost country should not be a risk factor in the transfer pricing risk assessment process.

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

Paragraph 74: Given the difficulty of appropriately documenting the price and benefit of royalties, management fees, and insurance premium payments, TEI agrees that they may present increased transfer pricing risk. For purposes of the transfer pricing analysis of these payments, we recommend that tax authorities take into account whether they merely pass-through unrelated party expenses, for example insurance recharges, which would indicate the payments have a low transfer pricing risk.

Excessive debt and/or interest expense (§ 3.2.1.6)

Paragraphs 76 and 77: We suggest that a comparison of the entity's debt level to that of the entity's multi-national group may be relevant to the risk assessment analysis of excess debt and interest expense but is not relevant to validate the transfer prices applied to transactions in goods and services between related entities. The price of goods and services should be measured based upon operating expenses, *i.e.*, before exceptional or purely financial transactions.

Transfer or use of intangibles to/for related parties (§ 3.2.1.7)

Paragraphs 78-80: TEI agrees that intangible assets can present unique transfer pricing problems. However, before diving into transfer pricing issues related to specific transactions between members of a multi-national group, tax authorities should first examine the intellectual property (IP) policies of the group, as well as the group's business model. While many groups centralise IP ownership in an IP holding company which concludes research and development service contracts with other affiliates, some groups have a decentralised IP ownership approach, whereby industrial know-how is developed and owned locally by local affiliates and is duly embedded in their transfer prices for goods and services. In that case, benchmarks of local profitability should reflect activities that include local intangibles and there is no need to cross-charge research and development costs to other affiliates.

Quality of contemporaneous transfer pricing documentation (§ 3.2.3)

Paragraph 87: This paragraph and the accompanying table provide a "practical checklist of important issues to be considered in a transfer pricing risk assessment . . . ." It is correct that the misuse of transfer pricing techniques may occur anywhere and at any profitability levels. However, the Draft Handbook is designed to save tax authority (and taxpayer) resources by targeting appropriate taxpayers and issues for transfer pricing audits – an endeavor that is hardly furthered by a "look everywhere" approach. The table therefore strikes us as unhelpful.

Indications of low transfer pricing risk (§ 3.2.4)

Paragraph 88: As noted above, we recommend this paragraph include an example of a Principal structure since most of the risks are concentrated in a single entity.

Specific tax return disclosures – information returns (§ 4.1)

Paragraph 92: The fourth bullet in this paragraph refers to "segmented financial results of each controlled transaction" noting that tax authorities may "often" require this information. However, such information may be impossible to provide given the financial reporting systems of MNEs or could be provided only through extraordinary efforts and substantial investments in information technology infrastructure. For the same reasons, such information would be equally unavailable for consideration of comparables. We therefore recommend striking this bullet from paragraph 92.

Contemporaneous transfer pricing documentation (§ 4.2)

Paragraph 96: The first sentence states that "many" countries require contemporaneous transfer pricing documentation. However, the range of required "contemporaneous" transfer pricing documentation is very wide, with some countries requiring detailed documentation while others only requiring the use of simplified forms. The Draft Handbook should not create the impression that asking for extensive contemporaneous documentation is a "best practice."

Paragraph 97: TEI applauds the statement that "the OECD is also considering, in connection with its transfer pricing simplification project . . . whether there are ways to simplify compliance and provide the necessary information with less burden to taxpayers." We strongly encourage the OECD to provide guidance on uniform related party information reporting as soon as possible to avoid the proliferation of inconsistent and duplicative reporting requirements. Such guidance would also assist less experienced countries in determining what information is helpful in their risk assessment process.

Paragraph 98: This paragraph notes that "transfer pricing documentation requirements seek" several types of information. With respect to an individual member of a corporate group, the third bullet mentions "consolidated financial data" of the member's group as a whole. We note that consolidated financial data is seldom part of transfer pricing documentation requirements and is mostly available on the company's website, especially for MNEs. We therefore recommend that the OECD strike this portion of the third bullet.

The fifth bullet gives the impression that it is good practice to ask for an evaluation of more than one transfer pricing method from a taxpayer. This would, however, essentially duplicate transfer pricing documentation requirements and the reference to "alternative" transfer pricing methods should be removed. The sixth bullet, which asks for a "description of the comparables used in the economic analysis," should be revised to either note that comparables are not needed for several transfer pricing methods or that comparables should be asked for only if they are relevant to the transfer pricing method at issue.

Commercial databases (§ 4.5.2)

Paragraphs 108-110: Given the limited access to data in, for example, Asia, Latin America, and Africa, this section (perhaps in Paragraph 110) should emphasise that in cases where local information is lacking, the use of regional or global databases is legitimate.

Patent Office (§ 4.8)

Paragraph 120: This paragraph notes that some countries work with their patent office to "help identify cases where cross border transfers of intellectual property have taken place . . . ." The paragraph fails to recognise that some of an MNE's most important intellectual property is not patented, and should be amended to include that fact. Otherwise, users of the Draft Handbook may underprice transactions with respect to unpatented IP.

Necessary legal provisions to facilitate access to information (§ 4.10)

Paragraph 125: We recommend, either in this paragraph or a separate paragraph, that the importance of respecting the confidentiality of sensitive business information be emphasised. As noted, disclosure of such information can substantially affect the underlying business of an MNE and place them at a significant competitive disadvantage.

Obtaining information relating to domestic potentially comparable businesses (§ 4.10.2)

Paragraph 129: This paragraph presents similar concerns to that of paragraph 55, *i.e.*, the use of "secret comparables" and information not available to taxpayers – tilting the playing field toward the tax administrator. It would also likely increase instances of double taxation. Further, accessing information from competitors presents the same confidentiality issues described above. We therefore recommend that the OECD discourage the practice of "allow[ing] tax administrations to obtain information directly from potentially comparable domestic businesses" rather than encouraging it by describing it as a "useful tool."

Risk assessment process – selecting cases for transfer pricing audit (§ 5)

In general: In TEI's view, it is especially important that transfer pricing case selection take place in an environment where tax authorities have a proper understanding of the legal and economic aspects of a particular MNE's business and the OECD should emphasise that point in this section of the Draft Handbook. Improper case selection inevitably leads to wasted effort by both taxpayers and tax administrations.

Paragraph 136: The risk assessment process set forth in this paragraph gives insufficient weight to the importance of taxpayer involvement, diminishing collaboration between the parties and increasing the risk of wasted effort on both sides. We submit that (i) a meeting with the taxpayer at the start of the risk assessment process and (ii) a review of the risk assessment report with the taxpayer before its finalisation, are essential steps in the process and will save tax authorities and taxpayers time and resources by minimising miscommunications and misunderstandings.

The Enhanced Engagement Approach (§ 6)

In general: As noted above, we are surprised that this section of the Draft Handbook is generally limited to a brief survey of current practices with respect to "enhanced engagements" with taxpayers. In our view, the promotion of a properly administered cooperative and transparent relationship between taxpayers and tax authorities should be one of the key aspects of the Draft Handbook because such a relationship has the potential to save significant audit resources on both sides, especially with respect to transfer pricing issues as the risk presented by taxpayer participants in the program could easily be assessed. We recommend that this portion of the Draft Handbook be expanded to set forth "best practices" in the enhanced engagement arena to encourage tax authorities to develop such an arrangement.

Paragraph 147: As noted with respect to Paragraph 136, TEI agrees with the statement in this paragraph regarding sharing of risk assessments with taxpayers so that business can have an opportunity to explain any misconceptions in the assessment and clarify aspects of the assessment that may have been based on partial information. When a transfer pricing audit results from this process, the taxpayer and tax administrators should work together to develop an effective and efficient audit plan.

V. Conclusion

TEI appreciates the opportunity to comment on the OECD's Draft Handbook on Transfer Pricing Risk Assessment. If the OECD believes our participation in the announced public consultation is warranted, we would be pleased to do so.[2] These comments were prepared under the aegis of TEI's European Direct Tax Committee, whose Chair is Alexander Kölbl. If you have any questions about the submission, please contact Mr. Kölbl at +41 58 158 88 97, Alexander.Koelbl@gdels.com or Benjamin R. Shreck of the Institute's legal staff, at +1 202 638 5601, bshreck@tei.org.

Sincerely yours,
TAX EXECUTIVES INSTITUTE, INC.

Terilea J. Wielenga
International President

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[2] TEI has participated in several previous OECD public consultations regarding transfer pricing, most recently in November 2012 with respect to the proposed revisions of the section on Safe Harbours in Chapter IV of the OECD Transfer Pricing Guidelines.