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To Pascal Saint-Amans, Director of the OECD's Centre for Tax Policy and Administration

Date September 27, 2013

From KPMG's Global Transfer Pricing Services professionals

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<u>Comments with respect to White Paper on Transfer Pricing Documentation</u>

Overview

KPMG welcomes the OECD's efforts at developing a systematic approach to documentation, as appropriate standardization would both make it easier for taxpayers to prepare such documentation and make it easier for tax authorities to audit. KPMG welcomes the OECD's acknowledgment that the current transfer pricing documentation rules as implemented by local tax authorities place a massive burden on taxpayers and that it is hardly possible for an MNE to follow a consistent documentation approach due to the differences in the country by country requirements. The goals outlined in the introduction to the White Paper, to simplify and consolidate the compliance obligations of business, if achieved, would provide the balance which is currently lacking in the approach to transfer pricing documentation.

However, KPMG has serious concerns about the specific approach recommended in the White Paper, which represents a significant departure from current documentation requirements. As a general matter, current documentation requirements start with information that is available to the specific taxpayer that is being audited, supplemented as needed by information provided by other members of the MNE Group (e.g., data on consolidated profits needed to use in a profit split analysis). In essence, most existing transfer pricing documentation rules require only information that would normally be available to the taxpayer, if the taxpayer was operating as an independent party.

In contrast to this, the documentation approach recommended in the White Paper starts with the proposition that, as a matter of course, the documentation provided to each local tax authority should include information which, while available to the MNE group, is not available to the local taxpayer, regardless of whether that additional information is or is not directly relevant to the approach used to support the arm's length nature of the specific controlled transaction. KPMG believes that this goes well beyond what is needed to allow tax authorities to conduct an effective transfer pricing audit.

KPMG's more detailed comments are as follows:

1) Transfer pricing documentation should be limited to the information that is needed for a local tax authority to audit the transactions that affect the taxable income of the associated enterprise that it is auditing;
2) The information necessary to perform a thorough risk assessment should be provided to tax authorities and can be supplemented, as necessary, after the risk assessment has been performed;
3) Current transfer pricing documentation rules often contain requirements that add significantly to compliance costs but very little value to the quality of the audit;
4) Requests for information from the parent of an MNE group (or other members of the group) should take into account both legal and business interests in confidentiality;
5) Taxpayers that provide effective transfer pricing documentation should obtain specific, measurable benefits from the provision of such documentation; and
6) Transparency should work in both directions – while taxpayers have an obligation to support the arm's length nature of their transfer pricing, their ability to comply with international and local regulations is significantly enhanced if they have a clear understanding of how tax authorities approach the risk assessment process.

Documentation should be Limited to Necessary Information

Tax authorities clearly have the right to the data and information needed to evaluate the arm's length nature of the transfer pricing transactions that affect the profits of the legal entities that they audit. Moreover, such information may be maintained by or pertain to members of the group other than the taxpayer under audit. Examples of such information include data on the functions and risks of the other party to the transaction (which is usually needed in the selection of the most appropriate transfer pricing method) and the financial data needed to compute profit splits. In some cases, such as when the profits of the member of the group are highly dependent upon intangible assets, this may even require relatively detailed information about the entire supply chain.

However, the fact that information about an overall supply chain is relevant in *some* cases does not imply that it is relevant in *all* cases. An MNE often has a very extensive and diverse set of transactions, and only a limited set of these transactions may affect the tax authority of a given country. As a simple example, an MNE with two separate supply chains (autos and clothing) should not have to supply information about its clothing supply chain to a tax authority that is auditing a member of the group that is in the auto supply chain, and vice versa. Moreover, it is difficult to understand why information about an MNE’s intangibles would be relevant to the audit of a member of the group that is simply providing back office services.

Transfer pricing documentation should be limited to the information that is needed for a local tax authority to perform a risk assessment of the transactions that affect the taxable income of the associated enterprise that it is auditing. Not only is the provision of irrelevant information costly to the taxpayer – even if the information has been prepared for another tax authority, there are costs associated with locating the information, translating it, delivering it to a different tax authority, and quite possible responding to questions about it. Moreover, the costs of the audit from a tax authority perspective are likely to be increased and the effectiveness of the audit reduced by the need to process information that is not relevant to the question at issue.

Given this, the starting point of any effective guidance on documentation should be a discussion of how to determine which information is relevant, and the documentation should be targeted at such relevant information. If the OECD in fact keeps the very extensive list of documentation requirements that are currently contained on pages 23-25 of the White Paper, taxpayers should have the option of explaining why certain of this information is not relevant to specific audits, and omitting such irrelevant information from their documentation packages.

A Two-Tiered Process that Focuses on Risk Assessment versus Audit

KPMG believes that the proposed documentation requirements laid out at pages 23-25 of the White Paper seem to adopt an “everything-but-the-kitchen-sink” approach rather than a true tiered process. More time and focus should be spent on ensuring that simpler and more straightforward compliance is achieved for taxpayers whose transactions are not considered high-risk. In addition, in order for taxpayers to better understand what makes them or their transactions high or low-risk, the risk scoring system should be discussed between tax authorities and taxpayers. This transparency is discussed in greater detail below.

KPMG believes that the proposed “tiered” approach to transfer pricing documentation (or “Coordinated Documentation Approach”), if adopted , should differentiate between a true assessment of the transfer pricing risk as a first step, followed as needed by the accumulation of the more detailed information on the way to a full-blown audit. In other words, KPMG welcomes the suggestion that tax authorities require, as a first step and as the only mandatory information to be maintained and provided, the kind of “big picture” information referred to at paragraph 71 of the White Paper.

KPMG believes that for the purposes of risk assessment, there are three key elements that should be considered as part of taxpayer’s documentation: a short overview of the business model and how value is created, a group structure, and a summary of the tested parties’ turnover and profits.

Whether further documentation is prepared by a taxpayer will then depend on its own assessment of risk. If a tax authority required further information because it had determined that there were material risks, that information could then be supplied from existing documentation prepared by the taxpayer on its assessment of risk, or could be prepared in order to address the specific points raised. All parties would gain from greater efficiency. Tax administrations would need to be prepared to give a reasonable amount of time to prepare such information, but this would be part of the balanced package that includes provision of additional information in the risk assessment phase.

Costly Requirements that Often do not Enhance the Audit

Current transfer pricing documentation rules often contain requirements that add significantly to compliance costs but add very little value to the quality of the audit. Examples of this include:

- Required formatting and third party involvement;
- Excessive requirements regarding comparable searches relating to regional sets and updates or use of specific databases;
- Local language requirements;
- The need to use local GAAP financials; and
- The lack of appropriate thresholds on materiality.

The White Paper acknowledges these issues, but fails to address them constructively. While there are clear issues around making documentation accommodate local needs (not all tax authorities speak English, the most common language used in preparing global documentation; materiality thresholds vary by country and type of transaction), these difficulties should not prevent the OECD from offering useful guidance (e.g., requiring only that summaries be translated in the first instance, with more extensive translation required only as needed to respond to specific audit requests; providing that updates of regional comparable sets every third year can be used unless there is a specific reason to believe that more local or frequent updates would lead to a significantly different answer; stating explicitly that the level of required documentation should take into account the size of the transaction and the level of transfer pricing risk involved).

Confidentiality Considerations

As discussed above, the White Paper very explicitly includes, as part of required documentation, information that is not normally maintained by or under the control of the specific member of the MNE group that is being audited. In many cases, an MNE may have a strong business interest or legal obligation to keep such information confidential from specific individual members of the group. This is particularly true in the case of information about employees of other members of the group, but also extends to information about profits and business plans/objectives. (Information about plant closures or business restructurings is often highly confidential, and the disclosure of such data could be very disruptive.) In theory, it may be possible to provide such confidential information to the tax authority but not the specific member of the group that they are auditing, but at the very least this is likely to impose substantial additional costs on the MNE as questions regarding such data would likely have to be handled by the parent company rather than the local entity under audit.

While confidentiality considerations should not allow taxpayers to avoid providing information that is necessary for an effective transfer pricing audit, they are an important consideration, particularly given the blanket request for detailed data about the personnel, profits, and business objectives of members of the group that are not covered by the audit. Any OECD guidance on documentation should therefore take such confidentiality issues into consideration.

Positive Incentives for Taxpayers

Past experience has shown that the most effective way of ensuring corporate compliance with documentation requirement is to provide MNEs with specific identifiable benefits from maintaining good documentation. In the United States, for example, there is no legal requirement to maintain transfer pricing documentation. However, the timely preparation of such documentation provides a specific benefit (penalty protection) and therefore the vast majority of taxpayers with significant international operations in fact prepare documentation.

Examples of possible benefits for documentation could include:

- Penalty protection or a shift in the burden of proof;
- Protection from use of secret comparables by the tax authority;
- Early identification of transactions where the tax authority agrees that the transfer pricing used by the taxpayer is appropriate, and possibly a need for reduced documentation around those transactions;
- Early identification and access to an effective dispute resolution mechanism in cases where the tax authority and taxpayer disagree as to the most appropriate transfer pricing. This is particularly important in cases in which two or more tax authorities are likely to differ on the most appropriate transfer pricing.

More generally, anything that either lowers compliance costs or which facilitates the effective and early resolution of any transfer pricing issues would be viewed as providing a significant benefit. Furthermore, tax authorities should ensure that transfer pricing documentation-related penalties do not become or are not applied as revenue generators. For instance, if transfer pricing documentation penalties are applied in more than 25% of transfer pricing adjustment situations, then there arguably is an issue with one of the following:

- The criteria for documentation is unclear as a significant portion of taxpayers do not seem to know how to meet it;
- The standard for documentation is too high as a significant portion of taxpayers are not able to meet it; or
- The application of the standard by the tax authority is too aggressive (i.e., the standard is reasonable and it is met by taxpayers but the tax authority nonetheless applies it in an unreasonable fashion).

Transparency by Tax Authorities

The documentation requirements set forth in the White Paper on pages 23-25 clearly represent a push on the part of the OECD to require increased transparency from taxpayers. However, to be most effective, transparency should work in both directions – while taxpayers have an obligation to be able to support the arm's length nature of their transfer pricing, their ability to comply with international and local regulations is significantly enhanced if they have a clear understanding of how tax authorities approach the risk assessment process. Therefore, to the extent that tax authorities have scorecards or issue lists that are used to identify "high risk" transactions, the factors that go into such scorecards or issue lists should be disclosed to taxpayers so that MNEs can either target their documentation efforts to transactions where they can expect audits or, if appropriate, modify their transfer pricing in response to tax authority concerns prior to an actual audit.