The Voice of OECD Business

BIAC Comments on the OECD Draft Handbook on Transfer Pricing Risk Assessment

September 13, 2013

Dear Pascal,

BIAC is pleased to provide comments on the OECD *Draft Handbook on Transfer Pricing Risk Assessment*, published on 30 April 2013 (hereafter referred to as "the Handbook").

We would like to congratulate the OECD on its efforts to improve consistency and transparency in risk assessment processes, as well as reducing unnecessary burdens for taxpayers and tax administrations, and welcome publication of the Handbook and its objectives to "provide clear and detailed steps countries can take" to assess risk. BIAC agrees with the need for such a Handbook, including particularly its potential use as a means of ensuring that the scarce resources of tax administrations *and taxpayers* are put to efficient use. BIAC is firmly committed to the success of this project and is pleased to assist in its development.

We have limited our comments in this letter to general comments regarding the Handbook and key concerns regarding its interpretation In addition, comments relating to specific paragraphs are included as an Appendix to this letter.

Limitations

The Handbook is correct to focus on the balance between resources required for the risk assessment process itself, and those reserved for audit cases. We consider that the Handbook should acknowledge explicitly up front that no risk assessment procedure can identify the cases for adjustment in all situations, nor will all cases selected for audit by the risk assessment procedure lead to adjustments if they cannot be sustained under MAP.

Further, whilst engagement in risk assessments is not as onerous as a full transfer pricing audit for taxpayers, co-operative taxpayers will still face some burden. It could be argued that the risk assessment process covers a lot of the same areas that would traditionally be covered as part of a transfer pricing audit, without any of the statutory safeguards that usually apply to such audits. We would welcome explicit guidance on how long a risk assessment should take (as a maximum) and that it should not place a disproportionate burden on taxpayers. We would recommend that the risk assessment should not exceed a time period of six months.

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Documentation

The preparation of Transfer Pricing documentation often represents a significant burden for businesses. There would be clear benefits to taxpayers and tax authorities if the level of documentation required could be modified according to risk status. BIAC recommends that the consultation on Transfer Pricing Risk Assessment and the recent White Paper on Transfer Pricing Documentation (released on 30th July 2013) should continue to be linked so that a 'low risk' status can bring tangible benefits in terms of a reduced documentation requirement as well as improved efficiencies in the overall audit process.

Equality

There appears to be a tension between formulaic numerical risk assessments and the use of judgement by tax administrations in consultation and debate with taxpayers. For more sophisticated regimes and larger taxpayers, more dialogue would often be much more helpful than a "mechanical" approach described in the Handbook. However for administrations still building transfer pricing capacity (and perhaps also for less well-resourced or sophisticated taxpayers) we recognise that a more formulaic approach may be necessary. We would welcome further guidance in which approaches the OECD would recommend in each circumstance.

We would also welcome explicit recognition that whilst risk ratings can help tax administrations focus their scarce resources, it is important to treat all taxpayers the same way and to ensure that risk assessment procedures do not result in disproportionate targeting of certain taxpayers (or groups of taxpayers). We consider that the size of a transaction or taxpayer should not be automatic indicators of high risk in and of themselves. Further, if and where a formulaic approach is used, we would welcome greater clarification on low risk and high risk triggers and the weight of their importance.

Links to the audit process

We would welcome explicit confirmation that where the risk assessment process determines an audit is necessary, a "deep dive" audit is not always required. The risk assessment process may instead only identify one or two issues on which the audit team ought to focus, and if these issues are investigated and satisfactorily resolved then a wider audit may not be necessary.

Further, we consider that the risk assessment process ought to be iterative, with risks continuing to be assessed during the audit. Should the audit uncover more information which could affect the risk analysis (either through eliminating issues or raising new ones) then these should be fed back into the risk assessment process to ensure the on-going best use of scarce resources.

Understanding the taxpayer's business and engaging in dialogue

Experience with these matters has shown that when tax administrations commence audits with little knowledge of the taxpayer, its industry, or the level of the industry in which it operates, there will often be conflict and poor results. Tax administrations may simply focus on the taxpayer's profitability or lack thereof. Tax administrations may insist on their own comparables, even if they do not understand the taxpayer's business and therefore are not really in a position to properly identify appropriate comparables. This may occur before the dialogue commences regarding the taxpayers own facts and view of its role within the industry and within its own group.

This practice frustrates taxpayers because it implies that they cannot resolve matters that make commercial sense, but instead must engage in a numbers game with the tax administration with the aim to create more revenue. This practice can be easily avoided by understanding the taxpayer's business better upfront, through some basic preparatory work to give a background understanding, followed by engaging with the taxpayer in constructive dialogue before the risk assessment is undertaken. We deal with this in greater detail below:

i) Background understanding

We consider that the first step in transfer pricing risk assessment ought to be taking stock of the taxpayer's business, including: how the business generates profit, its approach to tax planning, its supply chain, and the legal environment in which it operates. Tax administrations should also assess the historic relationship with the taxpayer. The introduction to the Handbook raises the importance of making "a serious effort to understand the taxpayer's business and how that business generates profit". We welcome this approach, but we note that significant focus in the following paragraphs on the detailed aspects of risk assessment may diminish the attention that it deserves. It is critical that the risk assessment team have a good understanding of the "big picture" aspects of the business in question, including its attitude towards compliance, before proceeding to a narrower assessment of transfer pricing risk.

In order to be as effective as possible, we suggest that the Handbook should therefore begin with a statement of the principles of transfer pricing, and more specifically encourage tax administrations to seek to understand the business in this context. For example, it would be helpful if tax administrations understand:

- The entity's related parties;
- What transactions it has undertaken with these related parties, including
    - The types of transactions; and
    - Volume and value of such transactions;
    - How these transactions are priced; and
- Why the business believes that the pricing is arm's length.

The taxpayer's transfer pricing documentation should be a good place for tax administrations begin. As the Handbook points out "many taxpayers seek to comply with transfer pricing rules" and in the process of doing so "they prepare accurate intercompany agreements reflecting the manner in which they conduct their business… clear transfer pricing documentation that describes their material cross border transactions, and describes in appropriate detail the functions, risks, and assets of various parties to those transactions". It is frustrating (and inefficient) for taxpayers to spend the resources necessary to prepare this documentation if they then have to respond to questions during audit from the tax administrations that indicate they have not read or understood that documentation, focussing instead on other methods of risk assessment. To the extent that the Handbook can be taken as an endorsement of documentation as a starting point, we welcome this view.

ii) Constructive dialogue

The work that the OECD is supporting through the Forum on Tax Administration (FTA) on co-operative compliance should be linked to the need for early, co-operative and transparent communications on assessing transfer pricing risks and executing audits.

Tax administrations may argue that transfer pricing documentation may not in isolation be sufficient to provide a "big picture" view of the MNE's business. Further, the underlying set of comparable firms may be imperfect despite the best efforts of the taxpayer. Thus, while transfer pricing studies are a good starting point, and an indication of arm's length pricing, a co-operative dialogue between the taxpayer and tax administration at the risk assessment stage regarding the taxpayers business, industry and growth model will enhance transfer pricing risk assessment and the productivity and quality of the audit (if an audit is considered necessary).

We note that this requires a willingness on the part of both parties to engage in such dialogue. In some cases, this may require fundamental behavioural changes. However, if taxpayers see the tax administrations have made efforts to read and understand their documentation as well as engaging in dialogue to understand the business before asking detailed questions, then this could help to create a level of trust sometimes missing in many tax relationships. Such communication also often results in other benefits to taxpayers and tax administrations, including (but not limited to) more efficient, timely completed audits, better usage of limited staffing resources during such processes, effective risk management, and the reductions of cost. We recognise that this is briefly covered in Paragraph 137, but we would favour a much greater focus on the advantages much earlier in the Handbook.

We believe that capacity building on the subject of co-operative compliance is the most relevant way of achieving a good dialogue between taxpayers and tax authorities. The FTA should be considered as a forum to allow exchange of best practices on the subject and we would be pleased to contribute to these discussions. From a Transfer Pricing Risk Assessment perspective, we are very keen to see the co-operative compliance approach endorsed early in the Handbook, as a precursor to narrower assessment of transfer pricing risk.

With all of these points in mind, we also consider that the preference for early engagement would be better highlighted if the current chapters in the Handbook were reordered as follows:

Proposed order	Current order	Chapter title
1	1	Introduction to Transfer Pricing Risk Assessment
2	6	Building productive relationships with taxpayers – The Enhanced Engagement approach
3	4	Sources of information for conducting a Transfer Pricing Risk Assessment
4	2	Questions to be answered in a Transfer Pricing Risk Assessment process
5	3	Assessing when Transfer Pricing risk exists and when it does not
6	5	Risk assessment processes – selecting cases for Transfer Pricing audit

Language and tone

We are concerned that the overall tone and focus of the handbook could result in a negative and sceptical view of taxpayers that could create misunderstanding at the risk assessment stage and lead to inefficiencies due to increased audits. The language used is often negative and the examples given often only explain where there is a high risk, implying that certain transactions are in and of themselves high risk.

We have detailed more specific instances of this in the Appendix, but also have some general comments and recommendations about how this could be improved:

i) Subjective language

There are multiple instances in the Handbook of references to “large” and “small” payments, as well as references to “material” payments, without explanation of how these terms are to be understood. We are concerned that this poses the risk of tax administrations disproportionately targeting MNEs with the largest value transactions (i.e. large MNEs), and we do not consider that payments being the largest (in monetary terms) identified by a tax administration necessarily results in them posing a higher risk, particularly where they may be routine payments that are well understood by the taxpayer and have accordingly been priced appropriately. The size of the transaction relative to the size of the taxpayer may be more appropriate as a risk assessment tool.

There are also frequent references to “high-tax” and “low-tax” jurisdictions. We would welcome acknowledgment that tax authorities should always be open to understanding the business (non-tax) reasons that may also drive businesses to locate activities in such jurisdictions. We would also welcome clarification on definitions of the terms used.

Further, we believe the related party transactions in the assessment must be reviewed in the context of the overall structure and commercial reality of the business dealings with the arm’s length principle being applied consistently, rather than these related party transactions representing a risk in and of themselves.

We would be particularly concerned if the use of such subjective language led to tax administrations ignoring the arm’s length principle in their transfer pricing risk assessments, as this could lead to audits that are inappropriately targeted, will not result in adjustments, and cause unnecessary burden to compliant taxpayers.

ii) Striking a balance between good tax payers and tax avoiders

We do not consider that the Handbook strikes the appropriate balance between responsible taxpayers (who consistently comply with their tax obligations and price their transactions appropriately under the arm’s length principle) and those that may seek to aggressively avoid tax. We consider that the discussions around which transactions may be high or low risk should give greater attention to this point throughout. Without this reassurance, Chapter 3 in particular appears to be a “checklist” of transactions that pose a high risk and should be questioned regardless of the taxpayer’s general attitude toward tax planning and tax compliance.

There is also very little discussion about the implications for taxpayers of a “not high” risk assessment. Transfer pricing documentation is a high burden for businesses, and there can be benefits to taxpayers if the level of documentation required to be prepared can be modified according to risk status.

iii) Presumption of problems

In particular, Chapter 3 of the Handbook focuses on assessing when transfer pricing risk exists. It identifies three main areas of concern, generally, risk from:

- Recurring transactions;
- Large and complex “one time” transactions; and
- Taxpayer behaviour relating to governance, tax strategies or ability to deliver compliance.

The Handbook also states that indications of profitability (or lack thereof), effective tax rate, and comparative profits of related parties are key criteria for review. While these areas should be looked at for purposes of risk assessment, we are concerned that identifying transactions for scrutiny implies that the transactions are inappropriate, and presumes there to be risks where there may not be.

Section 3.2 covers a very wide range of what could be considered “high risk” transactions, and consequently, it could be read to presume that the vast majority of international related party transactions should be considered high risk. We consider that the breadth of transactions covered may add little value to tax administrations seeking to focus their scarce resources if almost every transaction has to be fully examined.

This concern is heightened by the fact that examples given appear to relate solely to instances of high risk, and this implies there should be a presumption of high risk where such transactions are undertaken. In order to provide balance, we would recommend that the examples given (throughout the Handbook but particularly in Chapter 3 are broadened to demonstrate more indicators of low risk in these areas, and further clarification be made throughout that the mere existence of transactions similar to those covered is not in itself an indicator of high risk.

iv) Base erosion and stateless income

The Handbook repeatedly refers to “base eroding” payments and income “shifting”. Many deductible payments (rents, royalties, interest, or service fees) are required to compensate the other party to the transaction for use of assets or the performance of services. While deductible payments certainly reduce the tax base (compared to if the other party were not remunerated), it is unhelpful to consistently refer to transactions giving rise to a risk of base erosion in and of themselves. The mere existence of deductible payments should not alone be presumed to create transfer pricing risk. Rather such payments must be looked at in context and evaluated based on the surrounding criteria.

We welcome the work that the OECD is undertaking in the coming months to examine whether base erosion does pose an issue to the international tax system and, if so, how it can be addressed. However, we feel that inclusion of such references in advance of this work being completed is premature, and question whether a Handbook seeking to assist in identification of where transfer pricing rules have been objectively broken or applied incorrectly is the correct place for such language.

Transparency

Given the acknowledged advantages recognised by the OECD in the Handbook and in other publications of a “co-operative compliance” approach, we believe that the Handbook should explicitly recommend that any risk assessment report should be shared with the taxpayer.

In addition to the advantages that transparency gives in terms of developing trust between taxpayers and tax administrations, the purpose of risk assessment is to focus scarce resources, and by not sharing the results, considerable resources could be wasted in the early stages of any resulting audit which could be avoided by upfront transparency by the tax administrations.

Use of industry specialists

We strongly advocate the use of industry (non-tax) specialists in transfer pricing audits and we also strongly support their use at the risk assessment stage. Given the obvious advantages recognised in Paragraphs 18, 140, 141 and 142, we would welcome explicit recommendation from the OECD in the Handbook regarding the use of specialists at the risk assessment stage.

Sincerely,

Will Morris
Chair, BIAC Committee on Taxation and Fiscal Affairs

Mr. Pascal Saint-Amans,
Director of the Centre for Tax Policy and Administration
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APPENDIX: SPECIFIC COMMENTS

Chapter 1: Introduction to transfer pricing risk assessment

Paragraph 1: This paragraph focuses on the finite resources available to tax administrations. We consider that it is important for tax administrations to consider that taxpayer resources are similarly finite. Taxpayers may face expensive and time-consuming audits in multiple jurisdictions. Those audits may apply different and conflicting substantive transfer pricing standards. Further, a proposed transfer pricing adjustment may not survive local administrative or judicial reviews, and even where it does, access to competent authority processes for the relief of double taxation is sometimes limited and can be time consuming and expensive. We consider that Paragraph 1 should explicitly recognise the finite resources of businesses and advise tax administrations to consider taxpayer burden in determining whether an audit is appropriate.

Paragraph 3: In assessing whether to commence an audit, we consider that tax administrations should consider not only whether an adjustment would be sustained through the mutual arbitration process, but also whether an adjustment would be sustained through local administrative and judicial proceedings.

Paragraphs 5 – 13: As a general comment, we note that these paragraphs appear under the sub-heading of "*What is a transfer pricing risk assessment?*" Based upon our interpretation, we do not believe these paragraphs directly answer the question posed. Rather, as written, there is a discussion of background information that ends with a discussion of what the transfer pricing assessment seeks to do. We encourage the OECD to include a succinct and clear definition upfront of what a transfer pricing risk assessment is, taking into account particularly our comments below in relation to these paragraphs and our general comments above.

Paragraphs 5, 12, and 13: There appears to be a presumption that once a transfer pricing audit begins, it is necessarily a deep, detailed, comprehensive and conclusive process. This presumption may hinder one of the key goals of transfer pricing risk assessment - the effective use of scarce tax administration and taxpayer resources. Some audits may produce transfer pricing adjustments while others may not. Some taxpayers have significant and challenging transfer pricing issues while others do not. An effective transfer pricing risk assessment will establish not only whether to conduct an audit, but:

- The expected scope of that audit (narrow or broad);
- Its depth (a few confirming questions or a complete and comprehensive review); and
- Internal review procedures for assessing the effectiveness of the risk assessment and modifying or terminating the transfer pricing audit.

As such, we consider that the risk assessment process should be iterative, where the initial assessment may be revised or revoked in appropriate circumstances. We would consider it helpful if the language in these paragraphs were changed to reflect this, and an explicit comment to this effect was included.

Paragraph 8: By noting that certain taxpayers undertaking only certain transactions need not be subject to audit every year, this paragraph could be read to imply that other businesses (including all of those not undertaking "routine and readily understood commercial transactions") should be subject to audit every year. Transfer pricing audits require significant resources from business and the tax administrations, and the MNEs so it is not realistic in most countries to subject a fully transparent and compliant MNE to full transfer pricing audit as frequently as every year, and we believe that the implication otherwise is inconsistent with the resource constraints noted in earlier paragraphs.

Paragraph 9: There are three separate issues identified in this paragraph:

i. *"Shifting income into jurisdictions where it will be lightly taxed or engaging in related party transactions designed to erode the local country tax base - shifting income*" is an unhelpful phrase in the current context, and we do not agree with it. All international transactions produce income in two or more jurisdictions, each with its own tax rate and tax incentives. Similarly, all international transactions result in economic activity in multiple jurisdictions and so "erode" the tax base of one or more jurisdictions. These results are not only appropriate, but unavoidable. Their mere existence does not reflect that a taxpayer is non-compliant or non-transparent. We would welcome clarification that income should be taxed where the functions/assets/risks are performed so as to follow the economic and commercial substance behind the MNEs' structure whilst starting from the legal arrangements.

ii. With respect to not preparing full documentation, it is generally preferable if MNEs prepare comprehensive documentation, but this is a separate issue to non-arm's length pricing. A MNE could have all related party transactions priced at arm's length but simply not have full documentation.

iii. "*Not being fully transparent and /or preparing inaccurate documentation*" - this is illegal in most countries and clearly not acceptable behaviour.

Further, given the quite different nature and consequences of each of these three distinct issues, we consider it may be helpful to address them in separate paragraphs.

Paragraph 10: This paragraph suggests that an audit should be conducted where "reasonable people could differ over whether their transfer prices are arm's length." We would submit that, if reasonable people could differ, this could be seen as a contra-indicator for audit. A transfer pricing risk assessment should attempt to identify transactions involving clear and quantifiable mis-pricing, rather than simply transactions for which a range of prices could be argued to be reasonable.

Paragraph 11: We consider it would be useful to include explicit confirmation in this paragraph that fundamentally all taxpayers should be treated equally.

Paragraph 18: We agree that judgment is especially important in the risk assessment process and welcome the recognition that "it is likely that specialisation will be essential in the risk assessment phase". As noted in our general comments, we would like to see the OECD recommend the use of industry (non-tax) specialists to this end.

Chapter 2: Questions to be answered in a transfer pricing risk assessment

Paragraphs 21 - 31: As a general comment, it appears that this section seeks to identify controlled transactions and then ask if they are material. Most MNEs have material intercompany transactions, but where they are routine in nature they do not generally present substantial transfer pricing risk. We therefore consider that a better selection criterion might be whether the controlled transactions are "non-routine" for the taxpayer, rather than "material".

Paragraphs 24, 30, and 32: As noted in our general comments, we believe that risk assessment should primarily be aimed at detecting transactional cases that do not comply with the arm's length principle. Transactions that are routine and well understood by a taxpayer may involve larger amounts than those which are non-routine.

We are concerned that the language of Paragraph 24 regarding "how material…transactions are" and the references in Paragraphs 30 and 32 to "cost-benefit analysis", which could be read to imply that a monetary basis should be used to assess transactions, leading to the risk that tax administrations could disproportionately target MNEs with the largest value transactions (i.e. disproportionally target large MNEs).

Paragraph 27: We consider that inclusion of the term "what might be expected" is ambiguous and could lead to emotive outcomes. We recommend that a qualifying statement be added here to indicate that further detailed analysis may be warranted when "what might be expected based on objective criteria such as economics, business results […]" does not come to fruition. Further, we consider that "what might be expected" should not be viewed as a factor in isolation from other more objective criteria when conducting the transfer pricing risk assessment.

Paragraphs 28 - 29: Whilst it is correct that large related party transactions necessarily result in a reduction of a country's tax base compared to if the payment had not been made, where related party transactions are legitimate (and value is received by the payer in exchange), we do not believe that it necessarily follows that such payments "erode" any country's tax base, and we consider the implication that it does so is unhelpful. Further, the explicit naming of certain types of payments as those likely to create transfer pricing risk could be dangerous for both taxpayers and tax administrations, and we would recommend that these references are removed.

Paragraph 29: The last sentence of this paragraph states that consistency of the MNE's global policies regarding such transactions should be considered. We strongly agree with this, but suggest also the addition of language explaining that tax administrations sometimes apply inconsistent transfer pricing and other standards to determine inter-company prices and that taxpayers' deference to these competing policies should not in itself be flagged as a transfer pricing risk.

Chapter 3: Assessing when transfer pricing risk exists and when it does not

Paragraphs 38 and 73: Paragraph 38 notes states that "[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", and Paragraph 74 states that "Excessive royalties, management fees, and insurance premiums paid to related parties can be used to erode the local company tax base". We are concerned with this use of what could be construed as negative language. All allowable payments to related parties or otherwise reduce the level of profit and taxable income, and if appropriate transfer pricing policies are in place and consistently applied then this could conversely be an indication of low risk. We would welcome recognition of this point.

Paragraphs 38 and 40: Paragraph 38 raises a concern around the high volume of related party transactions within the extractive industries. However Paragraph 40 puts a very realistic limit on that concern, since for many extractive industries, readily available commodity pricing exists.

Paragraph 40: We question why concern is raised where both corroborative public market data is available *and* the transactions are with related parties in high tax jurisdictions. If corroborative public market data supports the pricing applied then we do not consider that this should pose significant risk regardless of the tax rate in the counterparty's territory.

Paragraphs 41, 71, 72, and 73: We are concerned with the subjective language used in these paragraphs. "Large" and "Small" payments are not defined terms and could encourage emotive decision making by tax administrations. Further, these are relative terms and, in the absence of substantial additional information about the controlled transactions in question, they do not allow for conclusion on the validity of the pricing for the transaction. The description of services as "non-routine" also requires additional clarification to ensure that it is understood to mean transactions that are not routine *for the taxpayer*.

We are also concerned that references to very common intra group transactions (such as payments for intangibles and insurance premiums) as potential causes for concern under these subjective qualifiers could lead to inappropriate or emotive targeting. Many companies commonly split activities and risks and engage in complex transactions involving royalties and intercompany management fees as a commercial reality, and the mere presence of such transactions are not necessarily indicative of risk. We believe the Handbook should stress that such a risk assessment of certain related party transactions needs to be balanced with the economic substance and commercial reality of the transactions, rather than these related party transactions representing a risk in and of themselves.

In addition, we consider that the absence of expected payments is also indicative of risk and should be added to the end of Paragraph 41.

Paragraph 42: We consider that tax administrations should attempt to ascertain (by requesting the relevant information) the *actual* losses of the related party before engaging in an exercise to try to understand the *likely* losses, and we would welcome confirmation of this point. We recognise that it may not always be possible to ascertain this information due to taxpayer confidentiality. However, there are clear benefits to seeking to ascertain this information where possible.

Also, this paragraph focuses transfer pricing risk assessment on the structure of the taxpayer's organization and in particular on "conduit" arrangements. Holding company arrangements are routinely entered into for valid business reasons, including management, financing, asset protection and other reasons. Such structures suggest nothing about transfer pricing risk in themselves, and the term "conduit" may have a specific and potentially pejorative meaning in some jurisdictions. We would therefore request that the wording be clarified to avoid such confusion.

Paragraph 43: Whilst we agree that business restructuring transactions, for example, do have the potential to alter the transfer pricing relationships between group members, we do not consider that such transactions "should generally be viewed as requiring additional scrutiny", and request that this be clarified to state that such transactions "*could potentially require* additional scrutiny".

Paragraph 44: This paragraph states that "In addition, most transactions involving intangibles, including cost contribution arrangements, can create substantial transfer pricing risk to the taxing administrations 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 minimization of tax." We agree that these related party transactions involve uncertainty and therefore may be difficult to value. However, cost contribution arrangements and similar related party transaction involving intangibles are not automatically put in place for purely tax avoidance reasons, and will more likely serve legitimate commercial reasons. We therefore suggest the remove of the portion of this sentence after the word “questions”.

We also request that this paragraph should make clear that the results of such transactions from past years (especially those which have been accepted as correctly price at the time of the transaction) should be respected in evaluating later-year transfer prices.

Paragraph 45: In our experience, some tax administrations have differing views of what “no data” means, and that often the benchmark is actually set higher than literally having no data at all. For example, where the local entity is in possession of a proper invoice for services from the parent company, this would seem to satisfy the data requirements of this paragraph. We would welcome additional clarity on this point.

Paragraph 46: We would welcome clarification as to why the "business sector" of a taxpayer is seen as an important factor in assessing the importance of a "lack of cooperation or a low level of compliance". We are also concerned that the way in which this paragraph is written could lead to some companies being unfairly targeted simply because others in their chosen industry are not complaint.

Paragraphs 48 – 51: We suggest that quantifying the amount of tax at risk at the risk assessment stage is inappropriate. It could place substantial and unwarranted pressure on exam teams to produce adjustments that support the quantified tax amount. It also may ignore mispricing by taxpayers who currently are paying cash tax (e.g., because they currently are in loss positions).

Paragraph 57: This paragraph states that risk assessment should consider a review of the other related party. We consider that many routine non-controversial intercompany transactions are easily benchmarked with very robust third party information available and there is no need to look beyond the local affiliate information to make that risk assessment.

Further, it is not always our experience that a company facing greater risks earns a greater share of profits. Risks sometimes come to fruition, with the party at risk suffering losses. This should not necessarily influence the level of profitability for the related party. We suggest that it would be helpful to add a caveat for this possibility.

Paragraph 58: We do not consider that the “whole of the group performance” is in line with a correct application of the arm’s length principle for testing the remuneration of a local affiliate. Functions, risks and assets should be assessed in line with OECD principles.

Paragraphs 59 – 61: These paragraphs state that an indicator of transfer pricing risk is that the taxpayer's financial results deviate from those of "industry standards or potential comparable companies." We suggest deleting references to "industry standards." A taxpayer's profits should be compared to those of companies with comparable assets, functions and risks. An industry standard analysis ignores that basic transfer pricing framework and could lead to numerous false positives (and false negatives) for transfer pricing risk assessment.

Paragraph 61: This paragraph invites evaluation of realistic alternatives at the risk assessment stage. We consider it unlikely that this would be a profitable expenditure of scarce time and resources at this stage, since understanding the presence of such alternatives requires a deep understanding of the taxpayer. In addition, the realistic alternatives concept is not well accepted or understood.

Paragraphs 62 and 64: We welcome the recognition of the potential business reasons for losses accruing in Paragraph 62. However, we would request that this is included in Paragraph 64 to clarify that losses of themselves are not necessarily indicative of transfer pricing risk.

Paragraph 65: This paragraph introduces the concept that a taxpayer may be negligent in not renegotiating a contract that currently produces low profits by industry standards. This is not an accepted concept for addressing arm's length transfer pricing, except where the contract allows for re-pricing following the fruition of specific trigger events. A contract is either binding or it is not binding. If, when consummated, the pricing appropriately conforms to the arm's length principle, we consider that its continuing results should be respected.

Paragraphs 66-68: Whilst we agree in principle, we consider that care should be used in the wording of this paragraph to emphasise that, where certain risk factors are present (such as an entity transacting with a related entity in a low-tax jurisdictions), this can indicate *greater* risk of mispricing, as the location of the entity alone does not create the risk. Emphasising that these factors can indicate *greater* risk, rather than just risk, would provide better guidance to tax administrations weighing up the potential risk factors they have noted.

Paragraphs 70, 72, 73 and 75: We are disappointed that intra group service transactions are identified as “one of the most frequently occurring transfer pricing issues” without further analysis of whether they should be. Such statements are likely to encourage the perception that intra group services are inherently high risk.

Further, contrary to the implications of Paragraph 72, we do not consider that all large intra group service transactions are "non-routine”. The prevalence of enquiries on head office services is a frustration for many businesses, and we recommend that the handbook gives further consideration to evaluating risk arising from such arrangements. The reference to procurement companies operating outside the country where manufacturing takes place in Paragraph 75 is unhelpful; procurement companies are usually located close to the sources of materials and components in order to fulfil their function.

Paragraph 73: This paragraph states that “It should be noted that experience has shown that intra group service transactions (including high value service transactions) are often not fully documented”. We consider that this statement should be revised or removed. Many taxpayers sufficiently document their intra group services and are making efforts to improve the quality of the information to satisfy the continuously increasing local transfer pricing requirements.

Paragraph 75: This paragraph states that “transactions involving these intermediaries may also tend to reduce income in the local jurisdiction”. We suggest the remove of the words “tends to” which may be inaccurate in many situations and may cause tax administrations to fail to consider the commercial realities or economic substance of such transactions. We do agree such arrangement constitute “a risk indicator that deserves further examination”.

We consider the words “accumulating income in such intermediary companies” unnecessarily imply that the use of intermediary companies (which may be part of commercially driven structures in a variety of industries, including but not limited to financial institutions) is questionable in and of itself.

Paragraph 78: We consider that bundling of intangibles may be inconsistent with arm's length pricing in some circumstances. This and other statements of substantive transfer pricing principles may now be or eventually become inconsistent with the OECD Transfer Pricing Guidelines (which we note are currently under consultation). We suggest deleting these types of provisions to avoid conflicting substantive rules.

Paragraph 79: The economic circumstances and characterisation of operating entities, including their functional and risk profiles, must be carefully considered prior to assessing whether the investment and costs of creating or enhancing intellectual property is commensurate with the income or loss and whether the allocation of income is reasonable given the assessment of such facts. That is, the correct transfer pricing treatment needs careful consideration of the facts of the given case with the umbrella of commercial reality at the forefront of the assessment. For example, in initial years, immediately after an investment in intellectual property, operating companies may generate operational losses, but that does not necessarily mean the conduct of the parties involved and allocation of income is not at arm's length. We therefore cannot agree that the lack of significant profits is in itself an indicator of transfer pricing risk.

Paragraph 80: In our experience it is the reality of MNEs that staff travel and are seconded regularly across borders. Routinely, seconding staff to other group companies should not be a flag for risk; it is simply commercial reality. Rather, the assessment of risk should be made as part of a proper examination of the control of and ability to assume the key risks associated with these highly skilled seconded employees. We therefore do not agree with the third bullet point in this paragraph.

We also consider the fourth bullet implies that that the nature of activities carried out by employees involving proprietary trading platforms or systems indicates that an intangible is created, without first assessing whether the activities lead to the creation of intangibles. We recommend this bullet point is balanced with a comment that a functional and factual assessment is first undertaken before any risk assessment that to ensure there is an intangible present in a given transaction.

We would also welcome explicit clarification in the final bullet point that it should be the company being audited (and not a related company) that owns the "well-known" brands.

Paragraph 85: We note references to the "quality" of taxpayers' transfer pricing documentation, including whether "credible" advisors were used in its preparation. We consider that this level of detail would be commensurate with a full audit rather than an initial risk assessment.

Paragraph 88: Whilst we agree that transfer pricing policies should be consistent across all territories and consider this to be best practice, taxpayers note considerable differences in local country legislation and the differing way in which OECD guidance is applied by tax administrations, which can lead to differences arising. This does not in itself result in a high risk and we would welcome explicit confirmation of this in Paragraph 88. We would also welcome further examples of low risk triggers to provide additional balance.

Chapter 4: Sources of information for conducting a transfer pricing risk assessment

General comments: We consider that it would be helpful for Chapter 4 to commence with an explicit clarification that tax administrations should ensure that where possible they have liaised with the taxpayer first in order to acquire a good understanding of how the taxpayer views their own business. When combined with the knowledge that tax administrations will have on their own taxation system, this will help the tax administrations appropriately direct their resources to identifying the most useful additional sources of information required.

The information that the Handbook suggests gathering for transfer pricing risk assessment is in many cases greater than what could be required for a full audit. We consider that it would be helpful to add some clarification that these are the *types* of information that *might* be gathered, but that an effective risk assessment process would identify some subset of information on which to base the assessment. With this clarification made, we would also suggest expanding the list of available information one or more sources of information that would allow the risk assessor to understand the economic and legal environment of the tested party's country or region. This would be most relevant where the tested party is not in the audit country.

Further, it should be made clear that research undertaken (for example through publicly available accounts, press releases, trade publications, group websites, analyst reports and commercial databases) may yield material that may not be accurately stated for the tax administrations' purposes, or stated in insufficient detail to draw any valid conclusion.

<u>Paragraphs 94 and 97</u>: We support the OECD's efforts to standardise information required for local reporting purposes, and to simplify documentation compliance efforts more generally. We would be glad to assist in this endeavor if requested.

<u>Paragraph 98</u>: This paragraph discusses the components of transfer pricing documentation. We note that the industry analysis component was excluded, presumably in error. We would encourage this item being added, or explicit confirmation as to the reasons for its exclusion.

<u>Paragraph 100</u>: We understand that in practice, many tax administrations may disregard taxpayers' contemporaneous transfer pricing documentation. We suggest including explicit encouragement to those responsible for transfer pricing risk assessment to start with a thorough evaluation and understanding of that documentation.

<u>Paragraphs 113 - 114</u>: We believe security analysts' reports should not be viewed in isolation as generally they omit facts and circumstances relevant to pricing. We also note that security analysts' reports generally consider all of a MNE's operations and not those of any individual subsidiary within the MNE.

<u>Paragraphs 115 - 118</u>: We strongly support the comments made in these paragraphs. We consider it would be beneficial to include these paragraphs earlier in Chapter 4 to demonstrate their importance.

<u>Chapter 5: Risk assessment process – selecting cases for transfer pricing audit</u>

<u>General comments</u>: We agree that a centralised process for assessing transfer pricing risk assessment is desirable to help ensure that fewer "non-issues" are flagged for audit, that fewer issues are missed, and that similarly situated taxpayers are treated similarly. However, we suggest that the Handbook explicitly recommend that risk assessors not be compensated or otherwise incentivised based on the size of any proposed adjustment. Such practices could encourage frivolous risk assessment adjustments. We further recommend that the risk assessors should not quantify the

amount of any potential adjustment, especially at the risk assessment stage, as this could create undue pressure for examination teams.

Paragraph 136: Whilst we agree with the steps listed at a high level, we believe they are perhaps too general in nature, and could be expanded to provide more specific guidance. Further, we consider that the open communication between tax administrations and taxpayers throughout the process (and particularly before preparing the final risk assessment conclusion) should be explicitly recommended within these steps.

Paragraphs 137, 138, 139 and 147: Paragraph 149 suggests that the transfer pricing risk assessment report (described at Paragraphs 137-139), should be shared with the taxpayers only where the tax administration seeks to establish a "co-operative relationship with taxpayers." We recommend that the Handbook recommend sharing with the taxpayer the transfer pricing risk assessment in all circumstances.

Paragraphs 140 - 141: Despite implication that dedicated personnel can be used to good effect in transfer pricing risk assessments, the Handbook does not reach a conclusion about dedicated personnel with substantial experience are required. If the proposition is for risk assessment to be used to target areas of highest risk in a systematic, consistent way, then we consider it essential that an experienced team should be involved.

Paragraph 142: We welcome the acknowledgment that risk assessments should be part of a continuing process, and should not stop at the commencement of an audit. However, we recommend that the Handbook more clearly states that risk assessment principles should guide the audit, with the result that if it is discovered that the issues are thought to be high risk are not so, that the audit should quickly be closed. Once started, audits are difficult to close, and it would be helpful of the handbook makes clear that if the audit discovers that the premise on which it is based is false, then the audit has succeeded in investigating potential non-compliance and should be closed.

Chapter 6: Building productive relationships with taxpayers – the enhanced engagement approach

Paragraph 143: We strongly support the overall tenor of Chapter 6. Co-operative compliance saves time, resources and costs and produces better outcomes. Tax administrations should be strongly encouraged to make available such co-operative programs. We would request that the suggestion in Paragraph 143 that discussions with tax payers "may very well be sensible" be replaced with a stronger endorsement of such an approach.

Paragraph 146: The last sentence of this paragraph is unclear and we would welcome additional clarity. As generally in transfer pricing matters, there are generally two sides on the related party transaction (i.e. Buyer/seller), which often means two different tax jurisdictions are involved. As such, any compromise on one side of the related party transaction with a tax administration could lead to complex unresolved aspects on the other side of the related party transaction.

Paragraph 147: This paragraph acknowledges that some tax administrations share risk assessments with the affected taxpayer. We would like to see stronger recommendations that risk assessments are shared with the taxpayer, and that this should be undertaken before conclusions are reached. The information available to a government will inevitably be indicative only, and its application to a particular taxpayer will be speculative to some extent, with the result that wrong conclusions could be drawn.