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By e-mail: TransferPricing@oecd.org

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Subject: OECD handbook on transfer pricing risk assessment

Dear Mr. Saint-Amans,

EY wishes to thank the OECD for the opportunity to submit comments in relation to the OECD's draft Handbook on transfer pricing ("TP") risk assessment ("Handbook"). This letter includes EY's key observations and recommendations for the revision or completion of the Handbook.

We welcome the OECD's initiative to prepare a handbook on risk assessment. A well designed and transparent risk assessment approach is of key importance for both tax authorities and tax payers. Our main observations relate to i) ground rules in the risk assessment process; ii) making a distinction between risk identification and risk assessment; iii) risk assessment as an integrated part of a TP audit; iv) potential TP risks; v) information gathering; and vi) a balanced approach for tax administrations and tax payers. Below we present our key observations and recommendations. An overview with more detailed comments in view of specific paragraphs of the Handbook is presented in the appendix.

Ground rules in the risk assessment process

In our view, an effective risk assessment process necessitates cooperation between taxpayers and tax authorities. In some territories this is self-evident, as the tax authority may have no power in law to require a taxpayer to provide information without commencing a formal audit. Even where tax authorities routinely obtain information about TP arrangements through information returns and required submissions of TP documentation, outside the context of an audit, further information may be necessary to be able to perform a good risk assessment.

Where taxpayers agree to cooperate with tax authorities in the risk assessment process through informal and open discussions about areas where the tax authority perceives TP risk, and through voluntary provision of information requested by the tax authority, this is likely to greatly facilitate the risk assessment process, helping the tax authority to identify areas worth pursuing further. Tax authorities must keep in mind that this type of cooperation is voluntary. Risk assessment should not effectively lead to an increase in the administrative burden for taxpayers. A well designed risk assessment approach will be beneficial for both tax authorities and taxpayers, and will prevent such increase.

We therefore suggest that the OECD should include guidance in the Handbook on "ground rules" representing good practice by tax authorities in conducting risk assessments. Applying these should ensure that the benefits to taxpayers of cooperating are easy to perceive and straightforward to obtain. We recommend that tax authorities consider adopting the following ground rules:

- **Agreed and finite process.** The risk assessment process should have a clear scope, with a clearly defined timescale, process and outputs. This may be achieved by taxpayers and tax authorities upfront agreeing on these items. This is important to prevent the risk assessment from morphing into an extra-statutory audit which provides taxpayers with none of the protections of the formal audit process (for example, time limits).
- **Defined outcomes.** The potential outcomes of risk assessment should be clear to taxpayers. One form of good practice, for example, is for the tax authority to award a formal risk rating (low, medium or high) to individual entities or to particular transactions, with corresponding consequences on the likelihood of the transaction or entity being selected for audit.
- **No automatic escalation.** It should be clear that potential risk areas will not be pursued further where the risk assessment process suggests that the actual risk is not significant. There should be no expectation that some issues will automatically be escalated to a full audit, merely because a risk assessment is being carried out.
- **Focus.** Tax authorities should use their judgment to identify those arrangements that realistically present TP risks, and should focus the risk assessment process on those alone. The risk assessment process should not be a "fishing expedition".
- **Mutual transparency.** Tax authorities should be recommended to provide transparency to taxpayers about their thinking. This means that they should be prepared to explain their concerns about particular transactions to taxpayers, and to substantiate their reasoning in cases where they do not agree that a particular transaction presents low or insignificant actual risk. In our view it is also good practice for tax authorities to share draft risk assessments with taxpayers, as it enables the taxpayers concerned to correct misunderstandings and/or provide additional information before the risk assessment is finalised.
- **Mutual benefits.** To stimulate taxpayers' voluntary co-operation in the risk assessment process, benefits for taxpayers cooperating can be introduced. Taxpayers who co-operate in "real time" (i.e., where risk assessment is contemporaneous with the transaction) should be entitled to automatic penalty protection in the event of a TP adjustment. Additionally, where a transaction or arrangement is classified by the risk assessment process as presenting low or insignificant risk, then it should be clear that this arrangement need be re-reviewed only infrequently (for example, no more often than every three or five years). Likewise, it should be clear that where such arrangements present low risk, the extent of TP documentation required can be commensurately low.

Risk identification vs. risk assessment

We recommend the OECD to articulate a clear distinction between risk identification and risk assessment. Section 2 of the Handbook does begin to differentiate between the process of identifying factors that indicate the potential for TP risk (section 2.2. – "*Is there an indication of TP risk?*") and assessing these risks (section 2.3 – "*Is the case worth an audit?*"). We think that this is an important distinction that deserves to be further elaborated in the document. For a risk assessment process to be effective, the potential risks that are identified need to be assessed to decide whether they are actual risks. It seems incorrect to characterise particular types of transaction or situations as intrinsically indicative of TP risk (as appears to be the thrust of section 3.2), but rather as indicative of *potential* risk which must then be assessed. In our view, the purpose of a risk assessment process should be to identify potential TP risks and then to eliminate any that do not present a risk in the actual circumstances. It should be the goal of tax authorities to award "low risk" status even to transactions that have the hallmarks of high TP risk, where risk assessment dictates that this be so.

The following distinction can be made:

- Risk *identification* is the process of identifying potential risk factors that suggest that there *may* be TP risk (such as: large volumes of related party transactions; transactions involving payments for interest, insurance premiums and royalties; transactions with entities in low tax jurisdictions, etc).
- Risk *assessment* is the process of gathering information from the taxpayer and other sources (as discussed in section 4 of the Handbook) and then critically assessing the potential risk factors that may give rise to TP risk in the light of this information, in order to judge whether any potential risk factor represents an actual risk of tax loss in any given case, materiality being one of the critical criteria.

Risk assessment as an ongoing process throughout a TP audit

The Handbook describes risk assessment as the activities that should take place in order for a tax authority to make a decision on whether or not to proceed to a full audit (paragraph 12). The Handbook rightly contains considerable discussion and warning about the heavy resource requirements of a full-blown audit, with the decision not to be taken lightly (e.g. paragraphs 6, 12, 32, 33). Yet, in our view risk assessment should not be limited to the decision whether to start an audit or not. It should also assist in deciding the type of audit to be conducted. Maybe even more important, the risk assessment process should be ongoing throughout an audit. In this way, tax authorities can make better use of their resources by treating risk assessment as an ongoing process, and designing a staged audit process with clear objectives for each stage.

If the initial risk assessment process leads to a decision to open a formal audit, then the tax authority should have a clear view of the issue or issues where it perceives actual TP risk. At this stage, the audit process should already be focused on these issues, rather than blossoming into an unfocused investigation of all the affairs of the company concerned. If the tax authority can then identify what further information would give it comfort about the specific issues where it perceives actual risk, then the audit process can proceed through further stages of focused information collection and assessment. At the end of each stage there should be a stage-gate at which the tax authority can make an informed decision about whether to pursue the audit further (or make an additional tax assessment) or discontinue the enquiry – in effect, a further risk assessment.

In practice, it would also be very helpful to have a mechanism in place which allows taxpayers to consult senior officials with the right level of authority to discuss issues like scoping and progress. It should be avoided that the risk assessment becomes a fully automated process.

We note the helpful language at the beginning of paragraph 12 which comments that risk assessment can be a continuing exercise throughout an audit, and we suggest that the OECD include additional guidance in the Handbook to explain how this principle can be applied to a staged audit process. We recommend that the Handbook will further elaborate on encouraging a more cooperative and less confrontational environment in relation to TP risk assessment throughout sections 1 to 5.

It should also be considered that some countries may have a very formalistic approach to TP audits and this may prevent their tax authorities from terminating the audit process after it has been formally initiated. In other words, local procedural regulations on tax audits may require the tax authorities to complete the audit and to take a formal decision. This may result in inefficient use of resources of the tax authorities in case they realize at an earlier stage of an audit that the risk is low. In such cases, local regulations may need to be amended to allow the stage-based audit process.

Identifying potential TP risks

As noted above, the existence of a potential risk factor does not in itself mean that there is an actual risk (i.e. does not mean that a TP adjustment is likely to be appropriate). In assessing whether any particular potential risk factor represents an actual risk, we think it is important to keep clearly in mind the reasons why the potential risk factor presents a potential risk. This will help direct the information that should be sought to assess the risk.

For example, large and complex transactions present a risk because the larger the transaction volume, the larger the tax impact of an adjustment, and the more complex a transaction, the greater the scope for potential disagreement over pricing. However, large and complex transactions in themselves do not present any incentive for taxpayers to manipulate transfer prices, and therefore *prima facie* an audit of a large and complex transaction should be no more likely to lead to an adjustment than an audit of a low volume or less complex transaction. Therefore, the work to assess whether a large and complex transaction represents an actual risk might initially focus on a review of the TP documentation provided by the taxpayer. A thorough functional analysis, a well-reasoned selection of TP method, and a detailed economic analysis with good comparable data (possibly with supporting analysis using a secondary method) might well provide sufficient evidence for a tax authority to conclude that the pricing of a large and complex transaction is unlikely to differ from arm's length pricing, and therefore no further audit should take place.

The Handbook suggests that poor or non-existent TP documentation is another indication for potential TP risk. This could imply that the extent of TP documentation and thus, documentation effort, correlates with the appropriateness of TP. We believe it is sound business practice to direct documentation resources to complex and risk transactions, while non-material/routine transactions could be expected to require less documentation effort. From this perspective, the extent of TP documentation can even negatively correlate with the TP risk, i.e. less risk can induce less documentation. We recommend that such notion will be included in the Handbook. The mere absence of documentation for low risk transactions should not convert those into potential high risk transactions. We suggest that the OECD includes language in the Handbook that if for any reason the non-material/routine transactions are selected for audit after the risk assessment phase, taxpayers should be given a reasonable time to still produce compliant TP documentation related to these non-material/routine transactions (we also refer to paragraph 47 of the Handbook in this respect).

In line with this, it would be useful if the Handbook includes guidance for the tax authorities to share their materiality thresholds with taxpayers so that MNE's can properly allocate their resources for TP documentation of various transactions occurring within the group.

Information gathering

In assessing any potential risk factor, we also think it is important for the tax authority to have clear hypotheses about why that potential risk factor may lead to actual TP risk, as this also will tend to direct information gathering towards the most useful facts. For example, the hypothesis may be that the wrong TP method has been used. In this case, the risk assessment might focus on the functional analysis of the taxpayer and the related parties with which it conducts transactions, to test whether the TP method is consistent with the functions, risks and assets of each party. In case the hypothesis is that the right method has been used, but with the wrong data, the risk assessment might focus on an analysis of the comparables used to price the transaction.

For some of the risk indicators suggested in the Handbook we see practical challenges in accessing the information relevant for conducting the TP risk evaluation. We believe this should not lead to an audit structure in parallel to the normal tax field audit. This would not help the tax authorities in light of shortage of resources and would also put additional burden on the taxpayers. To avoid this we suggest clarifying that the tax authorities' pre-examination should be based on existing documents typically required by the tax authorities.

Currently the information that tax authorities require from taxpayers for their risk assessment purposes varies across countries. Certain countries even require very detailed tax return disclosures. Some countries for example have introduced very detailed TP information forms. Completion of such forms is a very time-consuming exercise which often requires extraction of significant data from the ERP systems of taxpayers, analysis of these data and then presenting them in the format required. For some taxpayers it is in practice often not reasonably possible to disclose the details of all inter-company transactions in certain countries. This also involves costs which for large taxpayers can be material and in some cases can even exceed the amount of potential tax at stake from TP risks. At the same time, there is no clear understanding as to whether all information required on that form would be relevant and useful for the TP risk assessment purposes by the tax authorities. For example, it is questionable to what extent pricing information about each product sold in an inter-company transaction may be relevant in cases where the profit-based methods are used by taxpayers.

We would therefore suggest that the OECD should include specific guidance in the Handbook in view of harmonizing the information that needs to be provided to tax authorities across countries for their risk assessment purposes. Also should there be a focus on proportionality; the magnitude of information to be provided to tax authorities should be proportionate to the magnitude of the business of a taxpayer in the specific country.

According to the Handbook, in most cases risk assessment would rely on such sources of information as a TP information report and TP documentation. At the same time, in some countries a request of TP documentation may be formally allowed only upon a TP audit and it is arguable whether such documentation may be requested during a risk assessment process. Under these circumstances, tax authorities may open an audit in order to be able to request transfer pricing documentation/information. It is recommendable to ensure that in such cases the audit process can be stopped if it is obvious that the transaction is low risk, without a full formal end of audit report.

Balanced perspective

Tax administrations use different risk assessment approaches to select taxpayers and transactions for an audit. Some countries have made their risk assessment approach transparent. They require or encourage that for efficient audits (and compliance) taxpayers should focus their TP documentation on complex and high risk transactions. This type of transparency by tax administrations helps taxpayers to better allocate their resources when preparing their documentation. This way, a more proportional approach to document related party transactions can be achieved. Such transparency should also especially be promoted in countries with newly adopted TP rules as there is a great level of uncertainty among taxpayers in such territories in terms of the approach which would be applied by the tax authorities during TP audits in later years. Transparency would help tax authorities to build trust with taxpayers and to promote an open dialog. Again, taxpayers are then also better positioned to properly allocate their resources for documenting the important transactions.

According to the current direction of the Handbook, the addressee is the tax authority. In our view, to enable an efficient and effective tax assessment process, an alignment between the tax authority's approach and the taxpayers' approach should be encouraged. This means that ideally the tax authority and the taxpayers have the same understanding of what situations imply TP risk and which do not (or less). In particular harmonizing the understanding on which transactions and which TP can be considered as simple, straightforward and acceptable would be helpful for the taxpayers. It would help them to improve the material compliance of TP and to efficiently direct documentation resources. This ties into the OECD's projects on simplification of certain aspects of TP. We recommend linking the handbook on TP risk assessment to those other initiatives, e.g. the guidance on safe harbor rules and the TP documentation project. This would bring the considerations together in the consensus of all parties involved.

Closing remarks

EY hopes that these suggestions and recommendations in view of the Handbook are of assistance. EY would welcome the opportunity to contribute further either through participation in a consultation meeting or by providing further clarification. In the meantime, do not hesitate to let us know how we can be of further assistance.

If you have any comments or questions, please feel free to contact any of the following:

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Yours sincerely,
On behalf of EY

Thomas Borstell / Ronald van den Brekel

Appendix – Specific observations and recommendations

Appendix - Specific observations and recommendations

Without having the ambition to present an exhaustive overview of all observations in view of the Handbook, this appendix presents a number of observations and recommendations regarding specific paragraphs of the Handbook.

General

Throughout the document the phrases "*contemporaneous TP documentation*" and "*contemporaneous documentation*" are used. Of course, often TP documentation generated by taxpayers and their advisors is not contemporaneous, depending on the local requirements of different territories in respect of documentation. In our view all TP documentation should be considered during a risk assessment process, so we would suggest omitting the word "*contemporaneous*".

In a number of places in the document (e.g. paragraphs 66, 75) the phrase "*economic activity*" performed by an entity appears to be used as a shorthand for "functions, assets and risks" of that entity, in the context of assessing TP arrangements and the income allocation to that entity. We prefer the more holistic "functions, assets and risks" language of the OECD TP Guidelines, as the phrase "economic activity" seems to disproportionately emphasise the ongoing functions performed by an entity. In the context of a risk assessment it is important for tax auditors to be sensitive to the entire picture which of course includes taking into account the assets and risks of an entity.

Chapter 3

Paragraphs 57 - 61
These paragraphs indicate that it can also be useful to look at the results of the company in comparison to those of the related party which is on the other side of the identified controlled transactions. Such suggested approach raises concern since the results realized by such related parties may also be derived from inter-company transactions, and group results are no automatic indication of arm's length returns of its subsidiaries. Inclusion of this sub-section in the Handbook may indicate guidance to encourage such practice by tax administrations even before an actual audit, and as a result increase taxpayer's administrative burden on information disclosure.

Paragraph 80
The first two bullet points listed under this paragraph refer to common indicators showing that a company owns valuable intangibles. The first bullet point mentions companies producing well-known branded goods, such as clothes, food, drink, accessories, etc. However, this fact does not by itself indicate intangible ownership. For example, a contract manufacturer could produce these products on behalf of a principal who owns valuable intangibles, or a licensed manufacturer would license valuable intangibles to produce and sell these products, without owning the intangibles.

The second bullet point refers to company accounts showing significant amounts spent on R&D. Similarly, this fact does not by itself indicate intangible ownership. A contract R&D service provider's full expenditures could be on R&D activities conducted on behalf of a principal without owning intangibles.

Furthermore, this paragraph indicates that if a company routinely seconds highly-qualified or skilled employees to other group companies this is an indicator of TP risk. We suggest eliminating this factor as a specific risk indicator since the secondment of personnel is common business practice for many taxpayers and often has non-tax reasons such as social security or pension schemes. Also, the fact that secondment is listed as a potential risk factor may put secondment in a negative perspective and may easily lead to wrong conclusions by tax administrations when evaluating such situations.

Paragraph 84
This paragraph indicates that there are non-tax factors that might provide an incentive for improper transfer pricing, such as customs aspects. We recommend that language will be included in the Handbook to encourage tax administrations to have an open dialog with taxpayers with an aim to reduce/manage potential risk in this field, such as coordinate with other government authorities, or provide special rulings or APAs.

Chapter 4

Paragraphs 104-106
These paragraphs indicate that tax authorities could search for information generated from the websites of taxpayers, for example to confirm the accuracy of the functional analysis in the contemporaneous documentation and to check some of the facts described by the MNE to tax authorities. From our experience we would generally agree that the website could be used to verify factual information. However, usually it will be impossible to obtain any information about the allocation of functions, risks and assets between specific entities within the taxpayer's group, which will make it difficult to confirm the accuracy of the functional analysis.

Paragraph 104 also indicates that the websites of taxpayers may give useful information on for example forecasted sales. We recommend that the Handbook will include language stating that the information generated from public sources should be treated with great caution since the purpose for which the information is made public is typically different, and therefore could be inherently biased. Therefore, such public information should not be automatically taken by tax authorities as a matter of fact and should be considered in the relevant context.

Paragraphs 108-110
These paragraphs discuss the use of commercial databases in the risk assessment process, effectively by comparing the profits of a tested entity with the profits reported by companies in the database. In our view it would be recommendable including guidance in the Handbook for tax authorities to be cautious when using the results of database searches without an understanding of the functional comparability of an entity with the companies in the database. Therefore, before engaging in this process, a tax authority performing a risk assessment should ensure some level of functional comparability.

Paragraphs 115-118
These paragraphs indicate that site visits and meetings with company personnel are a source of information for tax authorities conducting a TP risk assessment. Although we welcome such interaction between taxpayers and tax authorities, we recommend providing more guidance and elaborate on the purpose of such visits/meetings in the Handbook. For example by indicating that such visits/meetings would take place as a gesture of the tax authorities to encourage cooperation from taxpayers to work together in order to effectively manage the risk. Furthermore, site visits and meetings are a typical element of a full blown audit; we recommend that the Handbook includes language cautioning that the audit does not take place before the audit actually starts.

Paragraph 127
This paragraph suggests that tax authorities could obtain information related to foreign associated enterprises through article 26 of the OECD Model Tax Convention. We think the wording would be more accurate if it said that double tax treaties based on the OECD Model Tax Convention, and containing an article with language similar to that of article 26 of the model, provide such authority.

Paragraph 129
This paragraph indicates that in some countries there is also a legal authority to allow tax administrations to obtain information directly from potentially comparable domestic businesses. If this is used as a risk assessment tool, careful attention should be given that this will not be used as a fact in the determination of the arm's length position regarding the taxpayer's inter-company transaction during the audit. This should be clearly communicated to the taxpayer, to avoid the use of secret comparables.

Chapter 5

Paragraphs 132-135
These paragraphs indicate that an appropriate tax administration organization is an important element for conducting risk assessments. We think that it would be helpful to share some country practice as examples in this section of the Handbook.

Paragraphs 140-141
These paragraphs promote the use of specialists. A thorough understanding of the business of the taxpayer by the use of specialists is something we encourage.