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OECD Committee on Fiscal Affairs
Working Party 6

Sent via email to TransferPricing@oecd.org

Comments on OECD White Paper on Transfer Pricing Documentation

Introduction and General Comments

Innovation & Information Consultants, Inc. ("IIC, Inc.") submits these comments in response to the request for comments on the WP6 White Paper on Transfer Pricing Documentation. We are an applied economics and finance consulting firm, providing expertise in the areas of transfer pricing, valuation, and industry analyses. We would like to thank the OECD Committee on Fiscal Affairs and Working Party No. 6 for the opportunity to comment on this very important project. We also commend the OECD for the substantial work done to date to attempt to bring a more coordinated approach to documentation. In our practice we deal on a regular basis with transfer pricing audits of large multinational businesses by tax authorities and we believe the experience we have gained in this work may provide interesting insights and enhance further discussions with respect to proposals regarding documentation of transfer pricing transactions. Therefore we gladly share our observations and recommendations with you. We have taken the liberty to focus our comments on the basic issues of the purposes of such documentation and the proposed tiered approach as opposed to providing drafting and editorial suggestions.

The globalization of our economy and the increasing widespread requirement for documentation of transfer pricing transactions makes this a timely endeavor from the compliance and enforcement standpoint as well as the business planning perspective. Individual taxing jurisdictions desire sufficient specific information to make informed risk assessments while businesses complain about the growing burden of differing documentation requirements in multiple jurisdictions. The White Paper correctly notes that a balance needs to be struck between these competing interests and is an important first step in attempting to find such a balance. We agree there is room for improvement in the documentation process and the two-tier proposal contained in the White Paper is a good start. However, we believe two important points need to be

made regarding the two-tier proposal. First the proposal must be viewed purely as meeting the *initial* documentation requirements of any tax authority that will be used to perform risk assessments and judgments regarding materiality. These requirements should not be viewed as the entirety of what a taxpayer will have to provide in terms of documentation during the course of an audit. Second we believe it will be important for as many members of the transfer pricing community to adopt such standards if and when they are promulgated if the benefits of such an approach are to be realized.

Before we discuss specific sections of the White Paper, we offer a few observations of our own, based on our experience in assisting taxing authorities and business in the review and provision of transfer pricing documentation. We agree that currently there is substantial variation in the documentation requirements from country to country. The need for some degree of standardization is certainly important and even if done only at the initial stage of the transfer pricing review process would undoubtedly be of great benefit to MNEs. However, we believe it important to strike the right balance and this can not necessarily be done with a fully standardized approach. For example, the White Paper focuses on comments from the business community that updating comparable searches every year and using local comparables is overly burdensome,[1] yet differences in legal requirements as well as changing economic conditions often render this mandatory if one is to observe a true arm's length result. We have observed both regional and country by country differences in economic conditions such that the use of local or regional comparables must be required.

The White Paper also notes correctly in paragraph 55 the shortcomings of documentation that is often "canned," representing a cut and paste of prior studies or those done for other jurisdictions without careful analysis of specific facts and circumstances within a given jurisdiction. This is clearly a significant risk of moving to a standardized approach to documentation and we are concerned that the two-tier approach recommended in the White Paper will exacerbate the trend. Whatever rules may be adopted regarding documentation, exceptions must exist where a detailed analysis is required. In addition specific, concrete enforcement and associated penalties must be elaborated with any documentation rules.

Another important point is that transfer pricing documentation requirements must be viewed not as the "end of the road," but rather a starting point by which tax administrations can perform an informed risk assessment and decide whether to engage in a detailed audit or examination of a specific issue or transaction. We would suggest that this may mean that initial documentation rules should be more streamlined, but should also provide guidance in terms of what additional documentation may be required once a taxing authority deems an issue worthy of a more detailed investigation. The White Paper seems to recognize this,[2] but its proposals do not. Here we agree with the view of business that materiality standards should be put into place as means by which all parties can prioritize various issues and focus on those that all parties

[1] See paragraph 40 of the White Paper.
[2] See paragraphs 64-66 of the White Paper.

agree would have a major impact. From our experience, the earlier in an audit such judgments can be made, the more focused, timely and effective the audit will be.

Coupled with this is the fact that tax authorities and taxpayers have competing incentives and interests which often leads to conflict, distrust, and disagreements. This obviously transcends the documentation requirements, but it is with the initial documentation filings that such tension often first appears. Taxpayers must understand their risks of compliance at the time they file their return just as tax authorities must objectively conduct a risk assessment based on the documentation provided to it by the taxpayer. This is a key point – the taxpayer is largely, if not exclusively, in control of the data and information by which the tax authority must make an assessment of whether the taxpayer is in compliance.[3] If the taxpayer is unable to provide sufficient, unbiased information as part of its initial documentation filing, then the tax authority will naturally believe that the taxpayer may not be in compliance and is often tempted to go on a "fishing expedition" which in the end generally serves no valid purpose other than to waste resources. As noted below it is critical that the documentation rules must deal with this issue through enforcement and penalties.

Specific Comments

Current Documentation Environment (Section II)

We agree with the general conclusions reached in the White Paper regarding the current documentation environment. It varies considerably from country to country and often there is a lack of "big picture" view of the MNE's global operations which would be helpful in putting the local country's transactions into perspective. We agree that there must be flexibility in any attempt to standardize documentation requirements. In our view, two key factors should guide the attempt to balance standardization and simplification with the need for accurate, reliable information regarding the arm's length nature of a given transaction. These factors are risk assessment and materiality. Both tax authorities and taxpayers perform risk assessments – sharing of this information up front would help streamline the initial process by identifying those transactions that are most likely to raise compliance issues.[4]

Greater focus and identification of the materiality standards as part of the documentation requirements would also enhance the assessment of risk and streamline the initial documentation demands.[5] It is our experience that in most major audits, the ultimate decision as to whether to proceed with a claim is largely based on the potential size of that claim, but that decision is often not made until long after the audit was initiated. Imposing materiality standards early on as part of the documentation

[3] See paragraph 58.

[4] As the White Paper points out some jurisdictions have implemented systems to permit such sharing of information; greater standardization of such an approach and sharing of information between taxpayers and tax authorities as well as among tax authorities would help. See paragraph 49 of the White Paper.

[5] For example, paragraph 70 bullet one discusses "material cross border transactions" but no guidance is given as to what might be considered "material." Obviously it will be different for different jurisdictions, but the documentation rules must provide guidance in this area.

requirements would help eliminate certain "marginal" issues from an expected value perspective while permitting greater focus and resources on those issues that are most likely to move forward and have a significant tax impact.[6]

Purposes of Documentation (Section III)

The White Paper identifies three reasons for requiring transfer pricing documentation (risk assessment; compliance with arm's length principle; information required for a complete audit). We would argue that these three "reasons" are not separate or different as the White Paper states;[7] rather each reason is part of the same objective but merely reflect different stages of the overall process of determining whether a taxpayer is in compliance with the arm's length principle. For example, documentation requirements to meet the risk assessment objective should be viewed as part of the initial documentation requirements. As noted above, if sufficient documentation can be provided early in the audit review, then appropriate risk assessments and materiality reviews may be performed early in the process. The other "reasons" for documentation requirements merely extend through the review process in terms of ensuring that the taxpayer's transactions meet the arm's length principle and that as the audit moves from initial review to completion, the information provided is sufficient to allow the tax authority to perform its audit. The goal remains the same from risk assessment through the completion of the audit – the tax authority must have sufficient information to determine whether the taxpayer is in compliance with the arm's length principle.

We agree with the principles elaborated in paragraphs 58 through 62. The taxpayer has the upper hand in terms of its control of the relevant information and it must be forthcoming in providing such. Our experience is that taxpayers may stonewall and fail to provide critical information until late in the process. Rules should be in place and enforced regarding timing of responses to documentation requests, particularly where a risk assessment and materiality review suggest a particular transaction may not be in compliance with the arm's length principal. It is also important to recognize that even if standardized documentation requirements are adopted, there will be situations where additional information must be provided. Finally the point raised in paragraph 62 regarding differences in the burden of proof from jurisdiction to jurisdiction implies that there should be different rules regarding documentation, although initial documentation rules may be applied in a uniform manner, recognizing that some jurisdictions may require additional information.

The White Paper recognizes the staged information needs of the audit process in paragraph 65. We would suggest greater emphasis be placed on this staged process in evaluating the nature and extent of documentation requirements through the audit process. It is important in our view to recognize the need for information to meet risk assessment and materiality objectives at an early stage of the process, and once

[6] The exception of course is where the issue itself may be of great concern to the taxing authority, but presumably part of that concerns stems from the magnitude of tax dollars at stake for certain taxpayers.
[7] See paragraph 63.

specific transactions are identified for further analysis, the taxpayer must understand that additional relevant information will be required to permit a full analysis of the taxpayer's compliance.

Two-Tiered Approach (Section IV)

The White Paper recommends a two-tiered approach to initial transfer price documentation requirements based on the EU's Guidance on Transfer Pricing Documentation issued in 2006. As noted above we agree with this approach in general terms as long as it is made clear that it reflects only an initial approach to documentation requirements sufficient for the tax authority to assess areas of transfer pricing risk and determine materiality related to specific transactions.

At paragraph 70, second bullet, the use of the term "recent" is vague. The final recommendations should clarify how many years it would consider to be recent – or alternatively, is this a case by case basis? The third bullet relates in part to intangibles and we understand that WP6 continues to investigate issues related to intangibles. One issue centers on the appropriate definition of what constitutes an intangible. With respect to this bullet and later discussions of intangibles, we believe the OECD should explicitly recognize that WP6 is engaged in refinement of transfer pricing issues related to intangibles and that there is an overlap between the intangibles work WP6 is currently doing with the definition and classification of intangibles in this document. Along these lines, the OECD should clarify the definition of "important intangibles" – i.e., are these intangibles that are used in ongoing operations to facilitate cross border transactions, etc.

At paragraph 72 the White Paper notes that management accounts, consolidating income statements and balance sheets and/or tax returns would provide a general sense as to how global income is allocated and where pressure points may exist in transfer pricing and this would enable one to perform a risk assessment. Based on our experience, we do not believe that this type of extremely high level information will permit one to perform an accurate risk assessment. The example given of a review of allocation of income relative to assets or employment is also not terribly useful, particularly when it comes to an analysis of intangible assets, business restructuring or levels of debt. Management reports and tax returns frequently contain conflicting data which often require substantial reconciliation necessitating more, not less information.

In addition to demonstrating the "robust comparability analysis" described in paragraph 73, we believe this paragraph should also include the need for the MNE to justify its selection of its transfer pricing methodology and why such methodology is superior to others.

We appreciate increasing the flexibility allowed in reporting information in a master file as discussed in paragraph 76. However, there is ambiguity in whether the MNE or the tax authority is the appropriate party that determines whether information is provided on a company-wide or business line basis. The last sentence seems to imply that the tax authority will have input into what is most relevant and be able to request

the type of master file it finds to be most useful. We believe that the company should be allowed to choose the method that is most appropriate, as long as it provides sufficient information to assist the taxing authorities in performing a transfer price risk assessment.

We also agree that translation is important and in fact it is often most important when documentation is requested from a country other than the country in which an audit is being performed and the native languages are different. Documentation rules should require provision of all documents in the requested country's language. Finally as evidenced by our comments above, we agree with the White Paper regarding the comments on materiality standards.

The coordinated approach contained in the White Paper in paragraphs 78 through 83 and Tables 1 and 2 provides a good starting point. As described in Tables 1 and 2 however, we do not believe that it meets all of the goals stated in paragraph 79. We believe it should accomplish the initial stage of the audit process, namely that of risk and materiality assessment. It will not, however, be sufficient to provide all of the information required for the tax authority to determine whether a transaction complies with the arm's length principle or to make a final decision on whether to issue a deficiency notice. This is especially true for large or complex controlled transactions. In our experience, for example, the functional analysis that is typically provided by a taxpayer does not contain the level of detail required to evaluate the transaction. Often the financial and operational data are incomplete or cannot be verified.

In addition paragraph 83, bullet 3 refers to the creation of proper incentives for compliance with the documentation requirements, but fails to propose any recommendations regarding enforcement mechanisms or penalties. We strongly urge the CFA to consider coordinating enforcement and penalties as a means to encourage compliance with any standardized documentation requirements.

If the objective of the two-tier documentation is to provide tax authorities with sufficient data to make an informed risk assessment and materiality assessment, then we agree with the approach as outlined. However, without considerably more information and data, one cannot expect the latter stages of the audit process will be accomplished in a reliable manner. Thus if the approach is to focus on the two-tiered approach and the type of data listed in Tables 1 and 2 we would strongly recommend that the requirements be made clear that this information is to be used solely as a basis for risk assessment and materiality review.

Specific comments on Tables 1 and 2 follow:

Table 1 - Masterfile:

- the management structure and key personnel location should also include descriptions of the key personnel by name and occupation

- the organization chart should focus not on legal ownership and legal entities but on functional or operational reporting or the both should be provided

- Description: We believe the OECD should also include a request for transaction flows involving payments between intercompany affiliates. Furthermore, we recommend that the OECD clarify the definition of "entities" and "groups" in the sixth bullet point under the "General written description…" heading. There should be clarity with respect to how the MNE is classifying entities (e.g., clearly distinguishing the potential differences between the legal structure and the functional structure).

- MNE's intangibles, the first bullet should include who makes decisions regarding the intangibles and who manages the operations from an operational standpoint

- MNE's intangibles: The paper should clarify what constitutes "material intangibles" in this section, as well as "important related party agreements related to intangibles." Specifically, guidelines or examples should define what intangibles are material and what agreements are important. Furthermore, we recommend including language sufficient to recognize the fact that some agreements may have been amended several times over the course of many years, and to the extent the agreements are "important," the MNE's provide a full history of these agreements.

- MNE's intangibles, bullet 2: this should include the justification of why and to what degree specific companies are entitled to returns from relevant intangibles

- MNE's financial and tax positions: The OECD has put in a placeholder "(x)" for the number of years of consolidated accounts. The OECD should clarify what parameters define the period of time taxing authorities need consolidated account records. Compilation and retention policies may differ significantly across different MNEs and we recognize the need for flexibility, however, we believe the OECD should clarify whether any minimum period of consolidated account records is required. With respect to the number of employees, we believe the OECD should request provision of these employees by both legal and functional in-country entity, to the extent a difference exists between legal entity and functional entity.

- MNE's financial and tax positions, bullet 2: we would recommend attaching copies of the APA's as an attachment

- MNE's financial and tax positions, bullet 5: this schedule should also segment the employees by operating function.

Table 2 – Local File:

- Local entity, bullet 1: this should also include the names and job descriptions of the applicable senior executives, as well as prior experience in the business

- Controlled transactions: With respect to the provision of "selected comparable uncontrolled transactions," we believe that MNEs should also provide a list of CUTs considered, but rejected, including the reason for rejection. Typically, this is a standard practice within the industry and would facilitate greater transparency in allowing taxing authorities to assess the reasonableness of CUTs, while also allowing MNEs the ability to add a greater level of rigor to CUT analyses used to support transfer pricing provisions.

- Controlled transactions, bullet 4: we would recommend a more detailed description of what should go into the functional analysis

- Financial information: We believe that the OECD should include language clarifying the use of "(x)" years for annual local entity financial accounts. While we appreciate the flexibility offered, the OECD should at the very least indicate the number of years corresponds to the business cycle, or some other minimum measure to help facilitate effective transfer pricing analysis.

Again we appreciate the opportunity to provide these comments and would be pleased to answer any questions you may have regarding our input. We commend the WP6 for undertaking this difficult task and look forward to the progress made to develop standard documentation requirements.

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