Dealing Effectively with the Challenges of Transfer Pricing

OECD

Dealing Effectively with the Challenges of Transfer Pricing



This work is published on the responsibility of the Secretary-General of the OECD. The opinions expressed and arguments employed herein do not necessarily reflect the official views of the Organisation or of the governments of its member countries.

This document and any map included herein are without prejudice to the status of or sovereignty over any territory, to the delimitation of international frontiers and boundaries and to the name of any territory, city or area.

Please cite this publication as:
OECD (2012), *Dealing Effectively with the Challenges of Transfer Pricing*, OECD Publishing.
http://dx.doi.org/10.1787/9789264169463-en

ISBN 978-92-64-16907-4 (print)
ISBN 978-92-64-16946-3 (PDF)

The statistical data for Israel are supplied by and under the responsibility of the relevant Israeli authorities. The use of such data by the OECD is without prejudice to the status of the Golan Heights, East Jerusalem and Israeli settlements in the West Bank under the terms of international law.

Corrigenda to OECD publications may be found on line at: *www.oecd.org/publishing/corrigenda*.

© OECD 2012

You can copy, download or print OECD content for your own use, and you can include excerpts from OECD publications, databases and multimedia products in your own documents, presentations, blogs, websites and teaching materials, provided that suitable acknowledgement of OECD as source and copyright owner is given. All requests for public or commercial use and translation rights should be submitted to *rights@oecd.org*. Requests for permission to photocopy portions of this material for public or commercial use shall be addressed directly to the Copyright Clearance Center (CCC) at *info@copyright.com* or the Centre français d'exploitation du droit de copie (CFC) at *contact@cfcopies.com*.

Foreword

This report is the result of work that was commissioned by the Forum on Tax Administration (FTA) and undertaken by a study group led by the United Kingdom. Since its creation in 2002, the FTA has grown to become a unique forum on tax administration for the heads of revenue bodies and their teams from 43 OECD and non-OECD countries.

In 2009 participating countries developed the FTA vision setting out that… *The FTA vision is to create a forum through which tax administrators can identify, discuss and influence relevant global trends and develop new ideas to enhance tax administration around the world.* This vision is underpinned by the FTA's key aim which is to….. *improve taxpayer services and tax compliance – by helping revenue bodies increase the efficiency, effectiveness and fairness of tax administration and reduce the costs of compliance.*

To this end the FTA undertakes a wide ranging programme of work to identify and foster best practices in the field of tax administration. In January 2011 the FTA's Bureau agreed that transfer pricing should be the subject of a priority project during the course of the 2011 work programme. The United Kingdom has led the work that culminated in the production of this report. The study team, which comprised the United Kingdom and the Secretariat of the OECD, was greatly assisted by contributions from member and non-member countries of the FTA (Argentina, Australia, Austria, Belgium, Canada, Chile, China, Denmark, Finland, France, Hong Kong China, Hungary, Ghana, India, Ireland, Italy, Japan, Mexico, the Netherlands, New Zealand, Nigeria, Rwanda, Singapore, South Africa, Sweden, Uganda and the United States). The study team also received important contributions from the business and adviser community. Their contributions are recorded in the body of the report but the study team would like to record their gratitude for the assistance they have been afforded in the course of preparing this report.

Caveat

National revenue bodies face a varied environment within which to administer their taxation system. Jurisdictions differ in respect of their policy, legislative environment, their administrative practices and culture. As such, a standard approach to tax administration may be neither practical nor desirable across OECD and affiliated countries. This OECD report should be read with this in mind. Care should always be taken when considering a country's practices to fully appreciate the complex factors that have shaped a particular approach.

FTA membership

At the time this report was prepared, the following countries were members of the FTA: Australia, Austria, Argentina, Belgium, Brazil, Canada, Chile, the Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hong Kong China, Hungary, Iceland, India, Indonesia, Ireland, Italy, Japan, Korea, Luxembourg, Malaysia, Mexico, the Netherlands, New Zealand, Norway, the People's Republic of China, Poland, Portugal, Russian Federation, Singapore, the Slovak Republic, Slovenia, South Africa, Spain, Sweden, Switzerland, Turkey, the United Kingdom, and the United States.

Table of Contents

Abbreviations 7
Executive summary 9
Preface 11
Chapter 1 Introduction 13
Chapter 2 Selecting the Right Cases 19
Chapter 3 Getting Off to a Good Start 31
Chapter 4 Governance Arrangements 37
Chapter 5 Maintaining Progress, Tackling Delay 41
Chapter 6 Reaching a Decision Point 49
Chapter 7 Resources, Skills and Use of Specialists 57
Chapter 8 Transfer Pricing and Developing Countries 67
Annex A Denmark 79
Annex B South Africa 83
Annex C France 95
Annex D Transfer Pricing Risk Identification and Assessment: the Perspective of an Adviser of MNE's 101
Annex E Cloud Computing 105

Abbreviations

ADR	Alternative Dispute Resolution
ATAF	The African Tax Administration Forum
APA	Advance Pricing Agreements
BIAC	Business and Industry Advisory Committee to the OECD
CAP	Compliance Assurance Process
CRA	Canada Revenue Agency
CRM	Customer Relationship Manager
DVNI	Direction des vérifications nationales et internationales
ENE	Early Neutral Evaluation
ETR	Effective Tax Rate
FAME	Forecasting Analysis and Modelling Environment
FTA	Forum on Tax administration
GAAP	General Accepted Accounting Principles
HRCP	High Risk Corporate Programme
HRMC	HM Revenue and Customs
IRS	Internal Revenue Service
IT	Information Technology
JITSIC	Joint International Tax Shelter Information Centre
LBS	Large Business Service
LSS	Litigation and Settlement Strategy
MAP	Mutual Agreement Procedures
MNE	Multinational Enterprise
NTA	National Tax Agency
SARS	South African Revenue Service
SAT	State Administration of Taxation, China
SKAT	The Danish Tax and Customs Administration
VAT	Value Added Tax

Executive Summary

The increasingly integrated nature of the global economy and the ongoing importance of Multinational Enterprises (MNEs) in that economy mean that questions of transfer pricing are some of the most significant tax issues that MNEs and tax administrations have to manage. These issues are significant not just because large amounts of tax can be involved but also because they can be complex and their resolution is dependent on a good understanding of the facts and specific commercial context of the case. Consequently, the resolution of transfer pricing disputes tends to be resource intensive for both MNEs and tax administrations.

This report is concerned with the practical administration of transfer pricing programmes by tax administrations. Technical analysis of how transfer prices should be computed in accordance with the arm's length principle is outside the scope of this report. Instead the report focuses on the practical experiences of a number of FTA member countries and some non-member countries. It also reflects comments made to the study team by transfer pricing specialists working for major advisory firms and by tax managers working in business and industry. Drawing on this evidence, the report discusses ways in which the management of transfer pricing programmes can be optimised, so that transfer pricing audits and enquiries are conducted efficiently and in a timely manner, for the benefit of MNEs and tax administrations alike. It is concerned with the practical steps tax administrations need to take to correctly identify transfer pricing cases that merit audit or enquiry and then to progress those cases to as early a conclusion as possible.

An initial survey of the current state of play in transfer pricing administration has confirmed that there is scope for improvement. Although some tax administrations reported that they settle the majority of their transfer pricing cases within12 months, most do not and the average elapsed time was around 540 days. Transfer pricing risks are among the largest tax risks that tax administrations are managing but rates of tax recovery resulting from audits and enquiries vary significantly.

The report identifies the key stages in the conduct of a transfer pricing enquiry.

Successful transfer pricing programmes are based on a clear understanding of these stages and how best to manage them. More specifically the report finds that:

- Effective risk assessment is an essential first step in the process. A number of techniques for identifying transfer pricing risk are discussed as are some of the more significant risk indicators. Tax administrations, business and advisers are all agreed that effective transfer pricing risk identification is an essential pre-requisite for more cost effective audits and enquiries that are completed in shorter timescales.

- Once a case has been selected for audit or enquiry the way in which it is opened is key to the eventual outcome. Early dialogue between the tax administration and the taxpayer is increasingly common and can be very effective in setting the scope of enquiry and in establishing the relevant facts. As far as possible, fact finding should be a collaborative exercise that is conducted to a timetable that has been agreed with the taxpayer. It helps if

the fact finding phase is as distinct as possible from later and more adversarial phases of an enquiry. The trend towards more real time working of cases is positive and can encourage earlier co-operation between tax administrations.

- Transfer pricing programmes benefit from an explicit governance process. The report discusses some of the approaches to transfer pricing governance that countries have developed. Robust and transparent governance arrangements provide an assurance to business about the consistency of approach to transfer pricing cases.

- Maintaining progress in transfer pricing cases can be a challenge but there are some common causes of delay and some specific practical steps that can be taken to address them. Alternative dispute resolution techniques, including Early Neutral Evaluation, may well be of value in transfer pricing disputes and their use should be explored further.

- It is important to recognise when the time has come to stop further fact finding and reach a decision in a transfer pricing case. Good governance can be of assistance in helping tax administrations make decisions, including whether to litigate. Internal appeal functions can also play a positive part in resolving cases.

- Transfer pricing cases place particular demands on tax administrations, as they often require them to deploy a complex mix of scarce skills and specialist knowledge. There is no single right way to meet this challenge but improving knowledge management and training are essential. External experts have an important part to play in supporting the transfer pricing work of tax administrations.

The report discusses the particular challenges that transfer pricing poses for tax administrations in developing countries. It discusses ways in which those difficulties can be overcome.

The FTA includes tax administrations from OECD and non-OECD countries and its members are well placed to share relevant experience and expertise with administrations that are developing their transfer pricing capability. The report recommends specific actions the FTA could take to support the work of tax administrations and other international organisations in this field. This support will be demand led and includes a focus on measures that will help to improve financial transparency that will assist in transfer pricing work and more generally.

Preface

Foreword by the Permanent Secretary for Tax of HM Revenue and Customs in the United Kingdom

Business, tax advisers and tax administrations alike see transfer pricing as one of their biggest risks. Business fears double taxation when adjustments to taxable profits have to be made following a transfer pricing enquiry, tax administrations are concerned that multi-national enterprises can choose how they allocate their global profits by the way they organise their affairs and as a result they can allocate profits to low tax jurisdictions without moving the underlying economic activity.

The OECD has produced Transfer Pricing Guidelines to help business and tax administrations apply the arm's length principle, which requires internal transactions to be priced as though they had taken place between independent parties. This study looks at the challenges tax administrations face in the process of selecting and working transfer pricing audits and enquiries. It brings together the experiences of business, their advisers and tax administrations to offer insights and suggestions as to how audits and enquiries can be managed more effectively and resolved more efficiently. The final chapter of the study focuses on the particular difficulties faced by developing countries in relation to managing transfer pricing risks.

HM Revenue and Customs (HMRC) in the United Kingdom has led the study working with the Secretariat of the OECD's Forum on Tax Administration (FTA). A number of FTA and non-FTA countries have worked with the team or otherwise made significant contributions, both in workshops and through bilateral contacts. A draft of the final report was circulated to FTA members and other participating countries during November. The objective of this extensive consultation was to ensure that the report would reflect the rich diversity of country experiences found in the FTA.

Important contributions have also been made by the Business and Industry Advisory Committee (BIAC), other representative bodies, the business community, their advisers and academics. Their contributions are acknowledged in the report.

The study team recognises that the range of experience of FTA member countries and other participating countries means that some of the recommendations in this report may be of more immediate relevance to some tax administrations than others and that each administration will find its own way to achieve the improvements proposed but with the knowledge that support from within the FTA is available to all.

I want to thank everyone who over the last year has given their time, advice and resources to help the study team complete this report. I want to thank in particular Melissa Tatton, Director of the Large Business Service in HMRC, and formerly head of transfer pricing, for her knowledge, skill and determination in delivering the study and Jonathan Leigh Pemberton at the OECD for the knowledge, co-ordination and experience he has brought to the study.

Dave Hartnett, Permanent Secretary for Tax, HMRC

Chapter 1

Introduction

This chapter discusses the importance of transfer pricing issues and the reasons why they have tended to increase in terms of both complexity and importance. It sets out some of the administrative challenges tax administrations have to face when managing transfer pricing programmes and the purpose of the study that resulted in the report. It describes the work programme and the results of the initial survey of participating tax administrations.

Transfer pricing in context

Large Multi National Enterprises (MNEs) generally operate on a global basis and are able to decide where to locate activities and how best to structure and finance them to take advantage of different market opportunities. As a commercial matter they need to determine how global profits should be allocated between group members so that they can measure performance and that involves deciding the transfer price at which goods and services should pass internally. However, MNEs also have large discretion in the way in which they structure their business models and set internal trading terms. As a result they are able to allocate some of their global profits to group members in low-tax territories without moving corresponding economic activity, assets, risks or functions. Issues also commonly arise because group members can be unsure how to price intra-group transactions, even when they have no tax planning motive. The complexity of MNEs and the fact that some of their intra-group transactions are not directly comparable to transactions undertaken between unrelated parties can make it difficult for MNEs to comply with transfer pricing rules.

Transfer pricing rules exist to address the potential mismatch between profit allocation and the distribution of risks, assets and functions across the group. They require MNEs to price, for tax purposes, their internal or intra-group transactions and calculate profits as if the transactions had taken place between independent businesses – the arm's length principle. This is the international standard set out in Article 9 of the OECD and United Nations model tax conventions and used by most tax administrations around the world[1].

The use of the arm's length principle attempts to ensure a consistent basis for profit allocation and also helps to prevent MNEs from suffering economic double taxation – taxation of the same profit by more than one tax administration. In addition, the arm's length principle provides broad parity of tax treatment for MNEs and domestic corporates, preventing distortion of their relative competitive tax positions.

In recent years the complexity and importance of transfer pricing risks have increased as a result of growing globalisation, cross-border mergers and the increasing sophistication of the financial sector. This added complexity reflects fundamental changes in the way MNEs operate and how they have developed their business models. For example, advances in technology mean that the global operations of MNEs are increasingly integrated and tend to be focused on regional rather than national markets. As a result internal supply chains, which often extend across borders, have evolved or been restructured to reflect these trends. In addition, intangible assets, such as patents and trademarks play an increasingly important part in the process of adding value. At the same time the contribution MNEs make to cross border trade has continued to increase. Direct assessment of the share of international trade that is attributable to intra-group transactions is difficult because little data is collected on trade transactions between related parties. However, a recent OECD study that looked at data that is available in nine OECD countries concluded that intra-firm exports of foreign affiliates already represent 16% of total exports. The study suggests that adding the exports of parent companies to their affiliates abroad, one could come close to concluding that export sales to related parties represent one-third of total exports, the proportion suggested by US trade statistics, which do track intra-firm trade[2].

As a result of these trends, the pricing difficulties that can arise because intra-group transactions are not directly comparable to transactions that commonly take place between unrelated parties, or because they involve the provision of highly specialised services and the use of unique intangible assets, are becoming more commonplace. It follows that where these factors are present transfer pricing enquiries and disputes require high levels of resource and specialist industry and economic expertise that is scarce within tax administrations and which may need to be obtained externally.

Against this background, it is not surprising that both MNEs and tax administrations see transfer pricing as one of the most significant tax risks they have to manage.

Administrative challenges

The internationally accepted arm's length principle and the existing guidance on its application provide a widely adopted framework for the resolution of transfer pricing issues. That framework and the analysis of the arm's length principle on which it is based are outside the scope of this report. But that framework is not designed to address the administrative challenges that tax administrations face today with respect to case selection and the auditing of transfer pricing cases. This report brings together practical experiences of tax administrations, business and their advisers to provide insights that are intended to help tax administrations manage their transfer pricing casework more effectively, speed up the resolution of issues and share best practice. It reflects the diversity of situations that tax administrations face, which are driven in part by underlying differences in the structure and size of their economies. This report also addresses the particular difficulties that tax administrations in developing countries have to face.

For the reasons already outlined, transfer pricing cases pose increasing challenges for tax administrations, particularly in terms of the resources needed to manage them effectively. Similar resource issues can arise for business and a particular challenge for revenue bodies and business alike is that transfer pricing cases are very fact and circumstance dependent. The costs involved in a major transfer pricing audit or enquiry can be significant as can the cost of steps taken by business to ensure they properly manage the tax implications of transfer pricing. Furthermore, transfer pricing disputes can last for many years, thereby increasing uncertainty for business around final tax outcomes in multiple jurisdictions. For business, it is important to achieve early certainty and single economic taxation. When tax rates are comparable in the jurisdictions involved, how the profits are allocated between them is less important to business, even though it still matters to Governments. Tax administrations are increasingly aware of the need to make best use of their limited resources and of the need to manage their relationship with business more effectively.

Improving the management of tax risk and developing relationships between tax administrations and large business have been two of the primary focuses of FTA work in recent years. The Study of Tax Intermediaries (2008), Building Transparent Tax Compliance by Banks (2009), Framework for a Voluntary Code of Conduct for Revenue Bodies and Banks (2010), and the Joint Audit Reports (2010), are examples of that work.[3] Some aspects of those studies – such as joint audits involving more than one tax administration, bedding out competent authorities in audit teams and engagement between senior management of revenue bodies and the boards of large business - are particularly relevant to the management of transfer pricing issues. The ongoing and growing importance of transfer pricing work for tax administrations makes the practical management of transfer pricing programmes a priority area for improvement. The FTA recognised this and decided to include a study of the administrative aspects of transfer pricing in its 2011 work programme. The title of the study, "Dealing Effectively with the Challenges of Transfer Pricing" makes the purpose of the work clear. The study has deliberately focused on the internal administration of transfer pricing by tax administrations. Closer co-operation between tax administrations by means of Advance Pricing Agreements (APA), Mutual Agreement Procedures (MAP) and Joint Audits also has the potential to further improve the efficiency of transfer pricing audits and enquiries. This is a significant issue in its own right, on which the FTA has already done some work, but it may merit further study at a later date, building on the findings of this report.

The work programme

This study commenced with a written survey of FTA member countries designed to capture a broad overview of current performance in the management of transfer pricing issues and the scope for improvement. The survey was not designed for publication in full but the principal findings are summarised in below. The survey was followed by a two day workshop which was attended by transfer pricing experts from 11 tax administrations[4]. The study team also spoke to the leaders of transfer pricing work in Singapore and China seeking their views on the issues discussed in this report. The Commissioners of the tax administrations in South Africa, Nigeria, Rwanda and Ghana were consulted about the particular issues that tax administrations in developing countries face when they tackle transfer pricing risks.

The study team sought private sector input into its work in two ways. Leaders of transfer pricing work in the "Big Four" advisory firms took part in a workshop at which they discussed their experiences of dealing with transfer pricing enquiries involving their clients. They saw scope for improvement in the way these enquiries are managed by tax administrations. Separately the study team approached BIAC to obtain the views of business directly affected by transfer pricing audits or enquiries.

The survey

The first step in the study was to establish key facts from as many FTA member countries as possible. Tax administrations were asked to provide a range of information including: their approach to risk assessment, how transfer pricing work is overseen, numbers of cases working at any one time, elapsed times for audits or enquiries[5], the average and median amounts of tax recovered over a three year period and the way experts are used. Although the survey of the results achieved by the transfer pricing programmes of various countries was not designed for publication[6] in full, a brief overview of the results helps to illuminate some of the practical challenges facing tax administrations in this area of work:

- The results confirm that transfer pricing risks are among the largest tax risks that tax administrations are managing.
- The cases are complex and involve extensive fact gathering.
- Although some countries reported that they settle the majority of their transfer pricing cases within 12 months, most do not and the average elapsed time was around 540 days[7].
- Some countries recover very little tax from their transfer pricing audits or enquiries whereas others recover very large amounts from almost all their audits.
- Obtaining information across borders is a particular issue for some countries whereas others have very effective international relationships and use their double taxation treaty networks to good effect.
- The stock of open cases tends to be high, usually in excess of the number of cases settled in one year and in some countries the number was as much as 3 or 4 times the average number of annual settlements.

- The ease of access to and the quality of relevant supporting documentation is a key practical issue for auditors.

- The risk assessment process is central to the success of transfer pricing programmes but countries approach this in very different ways, the differences in approach being driven to some extent by the different environments in which they are operating and the particular constraints they have to work within.

The structure and content of this report

Discussions with tax administrations, business and their advisers about tax administration performance on transfer pricing led to the identification of a range of key issues. This report has been structured by reference to those issues and the key stages in the process of conducting a transfer pricing enquiry, from case selection through to eventual settlement. It also includes a chapter that discusses the management of transfer pricing issues by developing countries.

Notes

1 Model Tax Convention on Income and on Capital (www.oecd.org/ctp/tt/mtc); United Nations Model Double Taxation Convention between developed and developing countries (http://www.un.org/esa/ffd/documents/DoubleTaxation.pdf)

2 Lanz, R. and S. Miroudot (2011), "Intra-Firm Trade: Patterns, Determinants and Policy Implications", *OECD Trade Policy Working Papers*, No. 114, OECD Publishing. http://dx.doi.org/10.1787/5kg9p39lrwnn-en

3 Study into the Role of Tax Intermediaries: www.oecd.org/dataoecd/28/34/39882938.pdf; Building Transparent Tax Compliance by Banks: www.oecd.org/ctp/ta/banks; *Framework for a Voluntary Code of Conduct for Revenue Bodies and Banks:* www.oecd.org/dataoecd/10/9/45989171.pdf; and *Joint Audit Report and Joint Audit Participants Guide:* www.oecd.org/dataoecd/10/13/45988932.pdf (Report) and www.oecd.org/dataoecd/10/11/45988962.pdf (Participants Guide).

4 Austria, Canada, Denmark, Finland, France, India, Ireland, Italy, South Africa, the United Kingdom and the United States.

5 For the sake of clarity the term 'audit' refers only to fundamental challenges to the arm's length price. Countries were not asked to provide information about audits whose scope is limited to ensuring that the legal requirements for documentation have been fulfilled. Some countries refer to fundamental challenges to the arm's length prices used as 'enquiries.' For the sake of clarity the term audit or enquiry is used in the rest of this report.

6 In some countries the number of cases settled in any year is small and publication of the full results could compromise taxpayer confidentiality as a result. That is why only summary information has been included in this report.

7 A precise figure is difficult to calculate because countries have slightly different bases for determining when a case commences and when it is concluded, some counting the time from when the return is received and others from the point when a firm decision to enquire into a transfer pricing risk has been taken.

Chapter 2

Selecting the right cases

This chapter examines the process of risk identification and how tax administrations go about selecting the right cases for transfer pricing audit or enquiry. It examines the information sources on which risks assessments are based and the different ways in which tax administrations approach the information gathering process. It includes a summary of the features that may suggest that a transfer pricing risk is present in a case. It considers the role of commercial understanding in the process of risk identification.

Risk identification

Effective risk identification and assessment are the key steps which enable tax administrations to select the right cases for transfer pricing audits or enquiries. Since its creation in 2002, the FTA has done a great deal to highlight the important part modern compliance risk management principles have to play in improving taxpayers compliance[1].

Tax administrations operate with finite resources. Effective tax administrations need to focus on maximising yield/tax revenues in ways that instill confidence and ensure the tax system is operating correctly. This requires a structured and systematic process for deciding what is important in a tax compliance context, how major compliance risks will be addressed and how to determine the most effective allocation of resources. This general advice is particularly relevant to transfer pricing work, given the demands it makes on taxpayers and tax administrations alike, and a structured approach to risk management starts with risk identification.

There are a variety of ways in which tax administrations select cases for transfer pricing audit or enquiry. At one end of the spectrum are those administrations that use sophisticated methods to identify specific cases as higher risk, for example by using computer systems to analyse and compare relevant data about businesses, or their engagement with individual businesses to identify particular risks and then prioritise them. At the other end are those tax administrations that select transfer pricing cases for audit or enquiry every few years as a matter of routine, whether or not specific risks have been identified. Other approaches fall somewhere in between and, for example, identify transfer pricing cases for audit or enquiry whenever the gross value of cross border transactions exceeds a given threshold. The more sophisticated the approach to risk assessment and management, the easier it is to focus resources on the most material risks and the less likely it is that audits and enquiries will be unproductive and waste the resources of business and tax administrations alike.

Discussions with business, their advisers and tax administrations indicate that where audits and enquiries are not based on effective risk assessment cases last much longer, and all too often the most significant transfer pricing issues are missed. As a result enquiries are more costly than they need be and much less effective in recovering tax revenue than they should be. Inadequate risk assessment and poor engagement with business by revenue bodies can cause particular frustrations for MNEs with sound systems for transfer pricing risk management who feel that they should be given a chance to demonstrate that their risks are well managed. Business believes it would be beneficial if tax administrations shared their risk assessments before committing themselves to an in depth audit of all the issues they have identified. This would allow businesses to explain any aspects of the risk assessment that were based on partial information, or a misunderstanding of the commercial context in which the transactions in question took place. Some tax administrations already do this. Business would welcome the systematic sharing of transfer pricing risk assessments, even in cases that are not selected for audit, as this would help them to allocate their own resources to the areas of most concern.

This chapter discusses how tax administrations can best identify transfer pricing risks. It considers how to obtain and use information from a variety of sources to inform the risk identification process. It looks at common indicators of transfer pricing risk and the importance of a good understanding of the business and the commercial context in which it operates. Some examples of how tax administrations identify transfer pricing risk in practice are also included later in this chapter.

Information sources – tax returns, accounts, transfer pricing documentation and questionnaires

The starting point for risk identification is usually a review of the tax returns and accounts of the relevant MNE. Many countries also require that taxpayers prepare a package of transfer pricing documentation, including basic factual descriptions of transactions and operations, relevant financial data, and economic analysis confirming the arm's length nature of the transfer prices charged. Where such documentation exists, it can form a basic starting point for a transfer pricing risk assessment. In some countries it is possible to discuss difficult transfer pricing issues with the tax administration prior to the filing of the return, which ensures that those issues are identified without any delay[2].

Some tax administrations require MNEs to supplement their tax return with a completed questionnaire that provides additional information about transfer pricing. In Denmark, for example, completion of the questionnaire (Annex 1) is mandatory where related party transactions exceed a specific monetary limit (currently 5 million DKK = $0.97 million/£0.56 million). Denmark uses the responses to the questionnaire it requires businesses to complete as the basis for a risk assessment process that is partly automated. A fuller description of that process is included in Box 1 below.

Others require MNEs to complete a transfer pricing questionnaire only after an initial review of the tax return and accounts by the tax administration. For example, South Africa also issues questionnaires (see Annex 2) but only after an initial review of the tax return suggests that there may be a transfer pricing risk to address. These questionnaires ask for additional information, including details of transactions with related entities in low tax jurisdictions, to help complete the risk assessment process. Other countries, for example France, rely solely on their own assessment of transfer pricing risk based on the accounts, tax returns and other information they can access without making formal requests to MNEs. Annex 3 provides an overview of the approach that France takes to transfer pricing cases, focusing particularly on the early stages. From that it can be seen that the information in the tax return is supplemented by a systematic review of information available from other sources within the tax administration, such as information provided about any "controlled foreign companies", and information available from external sources.

Box 1. The transfer pricing risk assessment process in Denmark

- The risk assessment process in Denmark has a three-step approach.
- The first step involves a comprehensive identification of risk areas. The second step is a computer based process bringing together tax information and details from publicly available data bases. The third step involves a review of tax returns and accounts to look for indications of transfer pricing risk.

Step 1: Overall risk areas

- In the first step trends and topical issues in transfer pricing are reviewed with a view to identifying specific risk areas, *e.g*. 'loss-making companies' or transfers of intellectual property'. Looking at the detail of the approach:
  - Transfer pricing leaders are asked to think about the full range of risk areas.
  - A group of transfer pricing specialists are brought together to evaluate and prioritise the identified risks by reference to four factors:
- How much tax is at risk because of each specific risk?
- What is the danger that the risk will spread within the MNE and to other MNEs?
- Are the relevant tax rules known to tax payers and easy to follow?
- How can the risk best be managed?
  - A prioritised list of risks is drawn up and forms the basis of a work program for the year. Most casework will be carried out on a project basis focusing on a specific risk area. For a number of years the key risk areas have been similar, with the main ones being loss-making companies and transfer of intellectual property.

Step 2: IT based

- The second step of the risk assessment process involves an IT process where taxpayer data held by the tax administration is combined with publicly available data (*e.g*. Amadeus) to narrow down the population of companies to be subjected to further consideration.
- For example, equity funds are known to be a high risk area. A comprehensive search of the Internet identifies a list of all companies bought or sold by equity funds in the past 10 years. The list has been developed by a university and is publicly available. Financial data for all of the companies on the list are found in Amadeus and criteria are then applied to narrow down to a manageable size the population of companies that might be suitable for audit.
- Using multiple indicators of risk can be helpful in identifying cases for audit in that the actual number of risks can of itself be a way of prioritising cases. With equity funds such multiple indicators could be large changes in interest payments, size of interest payments, dividends payments or country of ultimate owner. Other examples include legal form and structure, branches, activity description, nature and size of income, loss deduction, dividends or tax exemptions.

At the end of Step 2 there are lists of companies marked either 'potentially suitable for audit' or 'not suitable for audit'. All the ones marked 'potentially suitable for audit' will move on to Step 3.

Step 3: Manual intervention

- The third step is an examination of the tax returns and financial data of the companies to see if they should be subject to a transfer pricing audit. The step will lead to a list of companies suitable for audit – prioritised in case resources limit the number of audits that can be opened.

Information sources – third parties

In addition to the data provided initially by the business, tax administrations are increasingly using a range of other data and expertise, available both from other branches of government and externally, to refine their analysis and improve their assessment of transfer pricing risks.

Databases: such as the Forecasting Analysis and Modelling Environment (FAME) take information from a variety of publicly available sources and provide a way of finding companies that are carrying out broadly similar activities to the company under review. If the financial results of the company under enquiry are completely outside the range of the apparent comparables, though the breadth of the range makes this unlikely, this may be an indication that the case is worth looking at in more detail. However, a thorough analysis is always necessary to fully understand differences between a business and potential comparables. Where results are inconclusive tax administrations will need to consider other factors.

Customs data: It is possible to use data collected for the purposes of assessing customs duties to obtain details of cross border transactions, including those between connected parties particularly as Customs data tends to be collected and available in real time. However, the existence of a cross-border movement of goods is not always indicative of a transaction (as goods often move intra-group without change of ownership), and other transactions, such as royalty flows, do not show up in customs data. Moreover, without knowledge of the ownership of the intangible property rights associated with many goods it can be difficult to assess instances of under or overvaluation.

Patent office: In Denmark the central transfer pricing team has tried to build a closer working relationship with the Patent and Trademarks Office, in order to help identify cases where cross border transfers of intellectual property have taken place and to obtain a better understanding of what intellectual property a business is developing. However, patents can be very difficult to understand. Moreover, many intra-group transfers of intellectual property take place by licence without any notification of transfer to official registries. In a similar way, transfer or registration of a patent can take place without change of beneficial ownership and in these circumstances there would be no implications for transfer pricing. The UK has recently acquired data from its Intellectual Property Office related to overseas transfers of patents, design rights and other intellectual property to further inform transfer pricing risk assessment. The data is currently being analysed by HMRC's transfer pricing specialists.

Tax treaty intelligence, including JITSIC[3]: Information received from other tax administrations, either spontaneously or as a result of a specific request, may assist in identifying transfer pricing risks. JITSIC members, for example, have found spontaneous exchanges very productive in identifying, and therefore tackling, transfer pricing risks. Spontaneous exchanges of information under double taxation agreements are encouraged so that information is exchanged at the earliest opportunity ensuring that the deadline for opening a transfer pricing audit or enquiry is not missed.

Press reports, trade magazines and other information in the public domain: These sources can provide useful information on both particular companies and their trade sectors. Information on business sectors can help decide whether declining results for a company reflect a wider malaise for that particular business sector, or reveal that the sector was in fact rather buoyant during the period in question. Articles on business sectors may also indicate when a competitor has launched a rival product, which might explain a fall in sales for the company being reviewed.

Internet searches: Using the Internet can provide information on particular companies and industries. It is also possible to use the Internet to access some government agencies databases open to the public. One example is the Securities and Exchange Commission (SEC) database of returns made by corporations operating in the US.

Tax administrations often use a combination of these data sources to identify indicia or features of risk which inform their transfer pricing risk assessment. Using a range of sources can ensure that less obvious risks are not overlooked by the tax administration; this can also allow for cross-checking which can usefully eliminate concerns which in fact have no substance. The quicker risks and concerns can be ruled out, the more resource can be focused on risks which need further attention.

The process of risk identification is complex and requires judgement and cannot be reduced to a set of mechanical rules. The fact that a case displays some of the features associated with transfer pricing risk does not automatically mean that an in depth investigation is necessary or worthwhile. Advisers we spoke to emphasised the need to exercise discretion when considering the indicators of risk. For example, losses are a genuine feature of business life and not necessarily the result of intra-group price manipulation.

However, it is helpful to have a structured approach to the consideration of risk, as this can ensure that the assessment is comprehensive and any enquiries that do result are clearly focused and specific. The table below summarises the aspects of a case that are most likely to suggest that there is scope for transfer pricing risks to arise. It is not, however, an exclusive list of transfer pricing risks.

Table 1. Features that may suggest Transfer Pricing Risk

Feature	Brief Description
• Significant transactions with related parties in low tax jurisdictions.	Where transactions take place with lowly taxed and related entities there is a risk that mispricing will incorrectly attribute excess profits to the lowly taxed jurisdiction.
• Transfers of intangibles to related parties.	Transactions of this nature raise difficult valuation questions, especially where the intangibles are unique and consequently there is a lack of comparables[4].
• Business restructurings	The transfer pricing aspects of business restructuring were the subject of a specific OECD study published and incorporated as a new Chapter IX of the Transfer Pricing Guidelines in July 2010[5]. http://www.oecd.org/dataoecd/22/54/45690216.pdf
• Specific types of payments.	Payments of interest, insurance premiums and royalties to related parties because the underlying rights are highly mobile and consequently there is a risk that the payments do not reflect the true value being added by the related party.
• Loss making	Year on year loss making where there is no attempt made to change business operations or financing. Sustained losses may be evidence that the reported results do not reflect the true value of the business.
• Poor results	Similarly results that are not consistent with industry norms or with the functions carried on by the enterprise in the country concerned may be evidence that related party transactions have not been correctly priced.
• Effective Tax Rate	Significant variations between the effective tax rate reported at group level and the nominal rates to which it is subject can be the result of transfer pricing that allocates too much profit to low tax jurisdictions.
• Poor/Non-existent Documentation	Evidence that transfer prices and the methods used to compute them are inadequately recorded casts doubt on the reliability of the prices themselves.
• Excessive Debt	Debt that appears to be in excess of the amount that an entity could borrow if it were a free standing entity, or interest rates that appear to be in excess of market rates.

Business understanding and risk identification

There are two principal approaches to risk assessment. Tax administrations need to consider both of them.

Bottom up – this involves consideration of information about the cross border arrangements that are specific to the MNE and jurisdiction in question, especially those that are not commonly found in transactions between unrelated parties and that may distort the allocation of profits and losses between jurisdictions. Tax administrations need to be satisfied with any analysis submitted that seeks to demonstrate that these arrangements are on arm's length terms.

Top down – this involves an assessment of the profitability of the group's operations in the jurisdiction in the context of the overall profitability of the MNE group, taking into account the allocation of functions, assets and risks and the business sector in which it operates. If the profitability of the company falls significantly below expectations based on high-level economic analysis, further investigation of the reason for this and the pricing of significant transactions is required.

Both approaches are dependent on a good commercial understanding of the company, the MNE group and the sector. This can be built up from published sources and, where an enhanced relationship exists, from discussions with the leadership of the MNE group itself[6]. Understanding the specific business context in which related party transactions are being conducted is of critical importance, as is an appreciation of the results of the business in a particular country in the context of the overall MNE group. Commercially available databases, like Amadeus, that bring together the reported results of many companies and provide information about key financial ratios and sectoral variations are used by several countries to identify risk and inform their risk assessments.

Although information from these sources can be valuable in providing potential comparables within sectors and can therefore help to refine the risk assessment process, advisers emphasised the need for tax administrations to develop an understanding of the specific business model of each taxpayer. They noted that tax administrations do not always place enough emphasis on the need to achieve a good understanding of how a business is run before focusing on specific transactions. This view was echoed by tax specialists working in business. These specialists particularly emphasised the importance of understanding the business functions undertaken by different parts of a group of companies and how those interact before entering into detailed examination of specific aspects. The internal management of MNEs is commonly more concerned with functions and product lines than the specific legal entities through which they operate.

Business, their advisers and tax administrations all emphasised the importance of understanding the operations of an MNE, their sector and the economic context in which they operate including the impact of the present, difficult economic climate. This is an approach that many considered even more important when the business cycle exhibits exceptional swings and trading conditions that are very different to anything most have experienced before.

The use of specialists is dealt with more comprehensively in Chapter 7, but they have a part to play in effective risk identification. Many tax administrations use general tax auditors or tax inspectors to undertake the initial risk assessment, but a number also involve specialists to help make the finely balanced judgements required in identifying and assessing risk. For example, some tax administrations have developed a cadre of sectoral experts who have a good understanding of key sectors, such as banking, or the pharmaceutical industry. Advisers see sectoral specialisation as a positive

development, particularly when these sector experts are involved in the risk identification and assessment process.

In the UK, HMRC requires the case team that is reviewing a potential transfer pricing risk for audit or enquiry to consider seeking input from the relevant specialists, including, for example, economists, trade sector advisers and corporate finance specialists.

Recognising the value of specific knowledge of the business in conducting risks assessments, the Canada Revenue Agency (CRA) has recently revised its risk assessment to a two tiered approach using standardised risk assessment tools. The main features of the revised approach are summarised below.

Box 2. Transfer Pricing Risk Assessment in Canada

- The Tier 1 risk assessment incorporates an integrated team approach which encompasses domestic, international, aggressive tax planning and goods and services tax risks. The assessment differentiates inherent risk elements (resulting from complexity or change) from behavioural risk elements (related to taxpayer behaviour in the areas of governance, tax strategies or ability to deliver compliance) to ensure that both risk areas are effectively included in the global risk assessment. Tier 1 segments the MNE population into high, medium and low risk categories, which supports CRA's objective to focus its limited resources on the higher risk cases.

- The Tier 2 risk assessment is a more detailed risk assessment which builds on the results of Tier 1. It provides an efficient and effective way for auditors to further assess and document the specific risks in the audit. It also provides a means to develop a comprehensive audit plan.

- The Tier 1 risk assessment process for International risks, in particular transfer pricing, is supported by information obtained from an information return of non-arm's length transactions with non-residents. This is a robust, issues-based transfer pricing information return and the data from it is entered into a system that is capable of cross-referencing and matching information in other forms. The return asks for information about transactions with related parties of many different types, including partnerships and trusts. This is helping the CRA to extend its reviews of transfer pricing risks to include networks of organisations that are related and large when considered in the round, even if individual entities are not. The form can be viewed at http://www.cra-arc.gc.ca/E/pbg/tf/t106/README.html.

Annex 4 sets out how a major adviser of MNEs approaches Transfer Pricing risk identification and assessment.

The different approaches tax administrations take to the governance of transfer pricing programmes is discussed in Chapter 4 but case selection is often the first stage in the governance process. In the UK **a transfer pricing enquiry must not be opened (or any approach made to a customer that might be construed as the opening of a transfer pricing enquiry) without the prior approval of HMRC's Transfer Pricing Panel or Board which will consider a business case. This business case is prepared using a standard template and is a narrative document which** sets out the case background, the risk assessment work undertaken, the reasons for **and** against enquiry and any special features. The template is also used for recording later stage reviews and is a living document for control of the transfer pricing enquiry. As Chapter 4 explains, the governance process in Denmark also starts at the case selection stage.

Key thoughts for the chapter

The challenge for tax administrations is to maximise yield while ensuring that business and other stakeholders have confidence in the tax system. This requires transparent processes for deciding how tax compliance risks are to be addressed. This is particularly important in the context of transfer pricing audits and enquiries which can be very resource intensive for tax administrations and business alike.

Business, their advisers and tax administrations are all agreed that the benefits of effective transfer pricing risk identification include:

- More targeted and thus more cost-effective use of limited resources from a tax administration's perspective;
- Clearly defined documentation requests which reduce both the demands on business in providing the documentation and the time and other resource burdens on the tax administration in reviewing it; and
- Shorter timescales for audits or enquiries and for resolving disputes, which are clearly advantageous to both business and tax administration.

Notes

1 See for example Guidance Note - Compliance Risk Management: Managing and Improving Tax Compliance www.oecd.org/dataoecd/44/19/33818656.pdf and the more recent Evaluating the Effectiveness of Compliance Risk Treatment Strategies - Guidance Note http://www.oecd.org/dataoecd/59/3/46274278.pdf

2 The Compliance Assurance Process (CAP) pilot program for large corporate taxpayers in the United States is an example of a process that allows this to happen, although CAP is not limited to transfer pricing issues.

3 Joint International Tax Shelter Information Centre. Details can be found here: http://www.hmrc.gov.uk/avoidance/aag-jitsic.htm

4 The transfer pricing aspects of intangibles are currently being discussed by Working Party No. 6 of the Committee on Fiscal Affairs on the Taxation of Multinational Enterprises, through a Special Session on the Transfer Pricing Aspects of Intangibles set up for this purpose.

5 http://www.oecd.org/dataoecd/22/54/45690216.pdf

6 For a discussion of the Enhanced Relationship, see Chapter 8 of "Study into the Role of Tax Intermediaries": www.oecd.org/dataoecd/28/34/39882938.pdf.

Chapter 3

Getting off to a good start

This chapter is concerned with the initial stages of a transfer pricing audit or enquiry. It looks at the fact finding process and the part that early dialogue between the tax administration and the taxpayer can play and how best to frame requests for relevant business records.

The way in which a transfer pricing audit or enquiry is opened is a key factor in determining the time it will take and the quality of the eventual outcome. This chapter describes ways to improve the opening of transfer pricing audit or enquiries to ensure effective progress.

Fact finding

A successful and effective transfer pricing audit or enquiry is one that is focused and specific and, as discussed in Chapter 2, the risk identification process plays a critical part in laying the foundations for that. The next key step is the initial fact finding. Obtaining the right facts at the right time is an essential part of effective transfer pricing audits and crucial to the eventual outcome.

Feedback from tax administrations and advisers alike suggests that facts and data should be established before arguments about the application of transfer pricing principles to those facts commence. Unfortunately it is only too common for both parties to enter into discussion of complex technical arguments and the detail of transfer pricing methodology before fully scoping the problem and agreeing which facts need to be established. The experience of advisers suggests that the fact finding phase of any transfer pricing audit or enquiry should be clearly distinguished from later phases and should be as collaborative an exercise as possible. Making a clear distinction between fact finding and the more adversarial stages of an enquiry helps to avoid technical arguments arising before the issues and facts are properly understood. Premature technical disputes are a regular cause of delay and wasted effort in transfer pricing enquiries.

All tax administrations emphasised how important it is to be able to access business records relevant to transfer pricing audits or enquiries. For this report business records are either the underlying records of account of the business or specific records relevant to the pricing of the transaction under review and are often a mix of the two. At the stage of opening a transfer pricing audit or enquiry, tax administrations usually take one of two different approaches. Some issue an immediate, usually standard, request for relevant business records whilst others open a dialogue with business and find that an early meeting between the business, its advisers and the tax administration enables a more targeted request for business records to be made. Countries making a standard request for business records often find that their request can be facilitated by substantive rules requiring taxpayers to prepare a defined package of transfer pricing documentation describing the taxpayer's related party transactions and supporting the transfer pricing determinations that have been made with economic analysis. In many countries, failure to prepare such transfer pricing documentation may be cause for imposition of substantial penalties.

Early dialogue

Whether or not the first step in an enquiry is a formal request for business records, there is a considerable degree of agreement between tax experts in business, advisers and transfer pricing specialists in tax administrations about the value of early dialogue. In one case mentioned by advisers, the focus of the enquiry was business restructuring. The taxpayer invited the tax administration team to a meeting at which the taxpayer gave a presentation about the commercial background of the restructuring. The taxpayer provided replies to questions posed in advance of the meeting, together with supplementary information to answer questions that had not yet been asked. The tax administration team obtained an understanding of commercial issues and an overview of the facts much earlier than would have been possible through written enquiries.

Face to face dialogue on transfer pricing issues will generally be a more efficient and effective way to establish the overall commercial context of the transactions being reviewed and to establish the

facts. It is becoming increasingly normal practice in tax administrations to use face to face dialogue as a means of agreeing the scope of and next steps in a transfer pricing audit or enquiry.

Many tax administrations are moving towards real time working of large business enquiries and audits as a means of working more productively and achieving earlier certainty for tax administrators and business alike. In relation to transfer pricing this means business having early discussions with tax administrations about any restructuring and the potential impact on its transfer pricing policies. This makes it easier to identify cases that would benefit from a joint audit approach with another tax administration or an Advance Pricing Agreement.

Requests for business records relevant to transfer pricing audits or enquiries

The use of specialists is addressed in Chapter 7 but it is worth mentioning here the value that they are able to add at this early stage. Where sectoral or industry specialists exist in the tax administration, their involvement in these meetings can be very helpful.

Sectoral specialists can also help to frame requests for relevant business records. They are often able to advise, from personal experience, precisely what forms of relevant documentation are likely to have been produced and so help to ensure that any material requested will both exist and be of value to the enquiry. The Canada Revenue Agency already involves its sectoral specialists in the process of constructing information requests at the outset of enquiries. Industry experts also help focus HMRC's interventions and provide invaluable assistance in framing information requests and scoping out many areas of dispute.

Box 3. Example of UK's use of sector experts

In several transfer pricing cases involving the pharmaceutical industry HMRC used relevant experts to identify the nature and type of records which the businesses were likely to keep or were required to keep under industry regulations. This enabled information requests to be far more specifically targeted and importantly set out using industry 'jargon' where necessary. This approach was beneficial to both the taxpayer and the tax administration. It resulted in far smaller volumes of business records being requested and provided thus easing both the compliance burden on the taxpayer in terms of locating and providing it and the resource burden on the tax administration in reviewing it. Equally, it provided for less misunderstanding as to precisely what was being sought and consequently fewer but highly directed supplementary requests. Consequently, the time taken to resolve enquiries was significantly reduced.

Whatever the approach to obtaining business records - whether the tax administration makes use of early dialogue with the taxpayer to inform its information request, or prefers to make an immediate request for business records – all tax administrations emphasised the importance of obtaining the transfer pricing documentation held by the business as part of the fact finding process. This is why many countries specify what contemporaneous documentation needs to be maintained by MNEs and made available on request.

Generally tax administrations aim to provide guidance to MNEs on the transfer pricing documentation they should maintain. However, the extent to which specific requirements are spelt out in tax legislation is more varied. The spectrum ranges from those that have a very prescriptive approach to those where nothing is prescribed in legislation. Canada, for example, has specific provisions governing the maintenance and provision of documentation to support the transfer prices adopted by a business and this is backed up by a penalty regime[1]. In contrast the UK does not have specific statutory rules governing transfer pricing documentation but does provide guidance about the maintenance of transfer pricing records and how to ensure that they comply with general obligations to make accurate returns of income[2]. HMRC's guidance provides advice on what (1) primary accounting

records (2) tax adjustment records (3) records of transactions with associated businesses and (4) evidence to demonstrate an "arm's length" result it requires business to be able to provide and when these records need to come into existence. Similarly, Austria has no specific documentation requirements but a recent court decision has made it clear that the taxpayer must be in a position to produce data on which a prudent business manager would have been able to base a pricing decision.

In the experience of many tax administrations the crucial issue is not the quantity of transfer pricing documentation, including any formal transfer pricing report that is provided, but the quality of the information it contains and whether the facts support the documentation produced.

Tax administrations and business considered that there are advantages and disadvantages to the two general approaches to business records requirements. Where legislation sets out specific transfer pricing record requirements this undoubtedly provides some certainty for business, particularly as it relates to the imposition of penalties for inadequate or incomplete records. On the other hand legislative requirements are often criticised by business for imposing an undue compliance burden, particularly where the level of documentation required appears to be out of proportion to the amount of tax at risk for the controlled transaction under consideration. Some businesses welcome an absence of statutory requirements and are comfortable relying on the guidance provided, whereas others are concerned that because of the lack of certainty they err towards overprovision and incur unnecessary costs. Major advisory firms often need to review transfer pricing policies and the relevant business records for their clients in the context of certifying financial statements, and in some cases in connection with due diligence exercises associated with mergers and acquisitions. The level of risk of subsequent litigation can affect the depth of the review required.

Whilst some advisers and businesses raised the issue of consistency as between different tax administrations, most were unwilling to achieve consistency at the price of all tax administrations moving to the approach of the most onerous. Advisers also asked that tax administrations remember that the document keeping requirement in one tax administration can inform another tax administration of the documents likely to be available.

Despite these variations in approach the practical experience of tax administrations in dealing with business records is remarkably similar. Even where there is a statutory framework prescribing the business records, the quality of the information provided by business can be very variable. The sheer volume of business records can be an issue as well, making it hard to focus the examination on the business records that are relevant to the specific issues at the heart of the enquiry. Tax administrations felt that whilst this was a result of the inherent fact dependent nature of transfer pricing, the provision of business records could be used as a delaying tactic by business, or even a way of deliberately distracting the tax administration from the heart of an audit or enquiry. Tax experts in business too were concerned about the quantity of business records that are maintained to justify the transfer prices that have been used. They considered that business sees the preparation of voluminous business records as a way of minimising the risk that tax administrations will seek to make a transfer pricing adjustment. At the extreme, this can lead to the preparation of certain business records for their own sake.

There was a broad consensus that in formulating requests for business records tax administrations should keep at the forefront of their mind the purpose of the audit or enquiry i.e. to test the actual transactions against the arm's length standard and to return regularly to this to test the necessity of obtaining further information. As Annex 3 makes clear, in France the tax administration is careful to assemble as much information as it can before opening a transfer pricing enquiry and the first step in the enquiry itself is to meet with the taxpayer and agree what questions need to be addressed and over what timescale. Whilst in the first instance, the request may have to be fairly wide-ranging in order to

identify the extent and scale of intra-group transactions, information sought thereafter should be closely targeted not only to minimise the cost and inconvenience to the business but also to avoid obtaining large extracts from business records that then need to be reviewed but which do not necessarily help to address the key risks. Advisers emphasised that when business records are supplied it is important that tax auditors or inspectors take the time to study them. Where this is not done, enquiries tend not to be clearly focused.

Key thoughts for the chapter

The way in which a transfer pricing audit or enquiry is opened is key to the eventual outcome. The best audits and enquiries are focused and specific, and founded on sound risk identification. Sector experts can perform a key role in the early face to face dialogue that is increasingly used as the means to ensure that transfer pricing enquiries are properly focused, which is essential to the overall effectiveness of an audit or enquiry. Technical discussions rarely progress a case unless all the relevant facts have been established first. As far as possible, fact finding should be a collaborative exercise that is conducted in accordance with a timetable that has been agreed with the taxpayer. The trend towards more real time working of transfer pricing enquiries is delivering earlier certainty for taxpayers and business. It also encourages earlier co-operation between tax administrations in cases that could affect the tax position in more than one country, thereby easing pressures on the Mutual Agreement Procedure.

Notes

1 These requirements are set out in S274 of the Income Tax Act and further information about them can be found in the CRA's Transfer Pricing Memoranda: http://www.cra-arc.gc.ca/tx/nnrsdnts/cmmn/trns/tpm05-eng.html.

2 HM Revenue & Customs includes guidance on this issue in its publicly available manuals: http://www.hmrc.gov.uk/manuals/intmanual/INTM433030.htm.

Chapter 4

Governance arrangements

This chapter looks at the governance arrangements that tax administrations put in place to ensure effective oversight of their transfer pricing programmes. It includes some practical examples and a discussion of the project management of transfer pricing audits and enquiries.

Getting cases off to a good start lays the foundations for an effective and successful programme of transfer pricing audits and enquiries. But transfer pricing audits and enquiries are complex and resource intensive. For this reason they benefit from regular oversight at a senior level. The precise arrangements that tax administrations put in place are necessarily tailored to suit the scale of their transfer pricing programmes and the size of their organisations. Some countries have put in place management and governance arrangements that are specific to transfer pricing. Generally speaking these arrangements all aim to give senior managers a good overview of the current status of transfer pricing audits and enquiries that are underway and the opportunity to intervene at key stages. It also makes it easier to ensure that there is a consistency of approach to transfer pricing issues. Examples of different approaches to governance are shown in Boxes 4-6.

Box 4. Transfer Pricing Governance Arrangements in Denmark

In Denmark, SKAT have recently created a transfer pricing board to oversee their programme of audits and enquiries. The board comprises the heads of the audit units and the head of the central transfer pricing team. It is responsible for reviewing all complex and material cases. The most complex cases will go on the board twice. The review of the case will generally be based on a 1-3 page paper that is prepared by the audit team, but in simpler cases the review can also be based on an oral presentation from the head of the audit team in question. Based on these reviews, cases will be prioritised; specialists brought in, cases progressed or closed. The board replaces a central approval system under which all transfer pricing income adjustments had to be approved by the central transfer pricing office. In consideration of time constraints of the board, very simple and straightforward cases are not presented to the board, but in order maintain an overview of the case portfolio. SKAT also maintains a complete list of all working cases to ensure that they are subject to review and oversight at the right time.

Box 5. Transfer Pricing Governance Arrangements in Canada

In Canada there is no transfer pricing board but there is a central committee that is tasked with the oversight of cases involving "re-characterisation" of transactions undertaken, which involves a specific provision in the Canadian code. This committee reviews a case 3 times. In the 1st stage, a case is approved and guidance is provided regarding audit steps. In the 2nd stage, the case is reviewed again centrally as the taxpayer must be informed that the provision is being invoked at this stage. Senior managers from the tax avoidance team are brought in at this stage, as the provision is regarded as having some of the features of a General Anti-Avoidance Rule. In the 3rd stage, a final determination is made to re-characterise transactions and lawyers will be involved in this stage of the process.

Box 6. Transfer Pricing Governance Arrangements in the UK

- HMRC introduced a new governance system for transfer pricing enquiries with effect from 1 April 2008.
- The primary aims of introduction of the new system were to achieve:
  - more focused case selection through effective risk assessment,
  - faster and more effective working of cases, and
  - greater consistency in how cases are worked and in decision making.
- The three stages of HMRC's mandatory TP Governance are:
  - making sure the selection of a case is appropriate,
  - ensuring there is effective progress in a case, and
  - reaching the appropriate conclusion in a case
- A business case must be made by the relevant case team to HMRC's Transfer Pricing Panel or Board for approval prior to an enquiry being commenced. The business case must detail the extent of risk assessment undertaken and the conclusions drawn.
- Regular reviews are required to ensure that cases are actively progressed and any factors causing delay are tackled.
- Finally prior approval is required from the Transfer Pricing Panel or Board of any settlement proposals, before they are agreed with the taxpayer, or for a decision to litigate.

Central oversight of all its transfer pricing cases in this way allows HMRC to closely monitor its own performance and obtain robust management information

When cases become stalled, good governance ensures that managers are aware of this and can intervene. It is often easier for them to reach the conclusion that a case does not merit further pursuit, or should be narrowed in its scope, than it is for the audit or enquiry team itself to make the decision. Internal appeals processes can also be of value when the process of enquiry, or more usually negotiation, about any adjustment that is being suggested has ceased to progress. Further consideration of ways in which tax administrations are able to tackle delay is covered in more detail in Chapter 5.

Project management – a transfer pricing audit or enquiry plan

Governance arrangements of the sort described above usually include the requirement for a project plan to be agreed at the outset of an audit or enquiry and also help to ensure adherence to such a plan.

For example, in HMRC it is mandatory to have an action plan, although the exact nature of the plan will vary according to the circumstances of the case. Where the issues are straightforward and fact-finding and analysis limited, a simple plan may suffice. By contrast, in a complex case where there are several different strands of enquiry moving at different paces, with different team members or specialists involved, a more detailed plan will be needed.

Whatever the size of the case, however, key features of an effective audit or enquiry plan will often include:

- Initial scope of the audit or enquiry

- Resource planning: details of the team and the anticipated requirement for specialists/experts – internal and external

- Process and timetable: for detailed fact-finding, obtaining information and supporting documentation and interim analysis

- Process and timetable: for detailed review of findings, development of arguments and exchange of views with business and reaching decision point

Each stage of the audit or enquiry should have a clear timetable and an expected completion date. These include the date by which the tax administration will take the decision not to seek any further information and will proceed to form a view on the basis of the information it already has, the date by which the tax administration will prepare a resolution review and finally the planned date of settlement.

Such action plans usually operate as living documents and scoping and timelines are updated as the case progresses but at all times act to help maintain momentum in a case.

The most effective action plans are those that are drawn up and agreed jointly by both the tax administration and the business and their advisors so that all are tied into the process. Even where tax administrations are unable to agree their plan with the taxpayer, they still find it useful to share the plan and the timetable, informing the business how and when, if necessary, they plan to use their information powers to force co-operation. Whatever the level of engagement with, or co-operation by, the business a project management approach to the management of cases is considered by tax administrations, business and their advisors to help to maintain progress.

Key thoughts for the chapter

Good governance arrangements ensure that the right issues are picked up for audit or enquiry and that senior manager have appropriate oversight to ensure the progress of cases. Robust and transparent governance arrangements also provide assurance to business that there is consistency of approach in transfer pricing cases.

Chapter 5

Maintaining progress, tackling delay

This chapter analyses the principal causes of delay in transfer pricing audits and enquiries and how they can be overcome. It discusses the process of document examination and how large volumes of material can best be managed. The chapter includes a discussion of the importance of good communication between tax administrations and taxpayers and the role of advisors. It also considers what use can be made of alternative dispute resolution techniques.

The results of the initial survey show that transfer pricing cases tend to take a long time to resolve and that major cases can take many years. There are many different challenges to maintaining progress in a transfer pricing audit or enquiry. Although these vary depending on the complexity of the case, the experience and skills of the tax administration and the level of co-operation of the business and its advisers, the impact of delay is normally the same – additional cost for both the tax administration and the business. The parties in a transfer pricing case may have different views on the causes of the delay, but feedback from business, advisors and tax administrations suggests that there are some common themes. This chapter considers specifically the main causes of delay and the methods tax administrations, business and their advisors find most effective in overcoming them.

Obtaining and managing business records: documentary evidence

Requests for business records

Delay in obtaining business records is one of the aspects of transfer pricing that concern most tax administrations. A co-operative relationship between a business and a tax administration will generally ensure that the right business records needed for a transfer pricing audit or enquiry are provided within a reasonable timescale. However, where that does not happen, tax administrations need to have effective powers to obtain business records, backed by appropriate sanctions for non-compliance. Documentation regimes and requirements are covered in Chapter 3, some of which include specific obligations to maintain transfer pricing documentation. In Denmark, if the taxpayer has not provided the documentation or if the documentation is insufficient and the taxpayer does not comply with supplementary information requests, SKAT has the power to estimate the amount of any transfer pricing adjustment that may be necessary. The estimate must be supported by evidence. However, the courts are more reluctant to override estimates where the taxpayer has provided insufficient information to SKAT. The power to estimate the amount of any transfer pricing adjustment in cases of non-compliance with information requests acts as an incentive for the taxpayer to comply with such requests.

In countries where MNEs tend to operate through subsidiaries or permanent establishments and are not headquartered in the country, obtaining access to relevant business records that are not in the power of the local management can pose a particular problem for tax administrations. The CRA now regularly involves its lawyers in the early fact finding stages of an audit. This can be helpful, both in framing requests for business records and in demonstrating a readiness to enforce those requests if necessary. When the local management of a subsidiary or branch seems unwilling or unable to comply with an information request, contacting, or even simply signalling a willingness to contact, the Competent Authority of the country in which the MNE is headquartered and the senior managers of the MNE can be very effective. In one case Finland needed information from a parent company in Denmark and contacted their colleagues in Denmark. SKAT undertook its own audit and that helped close the case in Finland.

Business records: document management

Transfer pricing audits and enquiries are fact intensive and therefore the volumes of documentary evidence that make up business records can be very substantial indeed. In large cases involving many transactions, complex business models and supply chains, the volume of relevant documentation can be overwhelming. There can also be a tendency for tax administrations which lack relevant industry experience to seek substantially more business records than are really needed, or can readily be managed. In addition business raised concerns that tax administrations sometimes fail to recognise the limited resources available in a business to deal with extensive information requests. This underlines the importance of making any business record information requests focused and pertinent. On the

other hand business and its advisers can sometimes deliberately seek to overwhelm tax administrations with business records documentation, in the expectation that it will not be examined in any detail or, if it is, the enquiry or audit will be subject to lengthy delay. This is not, of course, an approach without risk for the business which can be surprised by material submitted to the tax administration if it has been provided without sufficient prior review.

Traditional methods of manual document review are not able to analyse volumes of documentation that can run into millions of pages within a reasonable timeframe. This is a problem that the UK faced in preparing a major transfer pricing case for possible litigation and which it overcame by involving an external law firm. The key points from that case are summarised below.

Box 7. United Kingdom Experience of using a Private Sector Law Firm to manage documentation

This transfer pricing case was the first in which HMRC had retained a private law firm, as opposed to using its in-house lawyers, to assist in the preparation of a case for litigation and to act as intermediaries with legal counsel who would represent HMRC in court. This was not a decision taken lightly, given the substantial cost to HMRC, but reflected the complexity and, in particular, the document management challenges posed. Involving the private sector law firm enabled HMRC to access its specialised document management systems and to take advantage of its experience in managing and controlling large scale documentation review exercises including the engagement of suitable paralegals to assist with the task. In this case around 30 000 documents plus 2.7 million pages of spreadsheets supplied by the taxpayer in response to an initial information request were reviewed in 4 months enabling efforts to be concentrated on key issues and a further, tightly targeted information request to be drawn up and issued within a correspondingly short timescale.

The importance of good communication

The FTA Study of Tax Intermediaries recommends an enhanced relationship between tax administrations and their large business customers. This relationship is to be built on engagement at all levels from the Board down. There is growing evidence from tax administrations and tax advisors alike that good quality engagement improves compliance and early resolution of issues. Poor engagement in transfer pricing can result in protracted and unfocused audits and enquiries creating unnecessary costs and uncertainty for all.

Chapter 3 explains the value of face to face meetings at the outset of an enquiry. Such meetings serve to ensure that the business is properly understood and the scope of any further investigation is appropriate. Maintaining good communications with the business and their advisers during the course of the enquiry is important too. There are a number of relatively simple ways in which channels of communication can be kept open and progress maintained.

While transfer pricing enquiries inevitably involve the examination of a significant amount of underlying documentation and subsequent analysis, which needs to be set out in writing, lengthy exchanges of correspondence are often less effective than maintaining ongoing and face to face dialogue about the issues. If the audit or enquiry team is proposing an analysis of the facts that is likely to lead to an adjustment it is important that the reasons for doing so, given the facts of the case, are clearly understood. That understanding is often more easily achieved through a face to face discussion. The advisers we spoke to said that the reasons for proposing an adjustment were not always clearly set out.

Box 8. Example – the South African Revenue Service (SARS)

SARS has recently placed much greater emphasis on face to face negotiation and intensive discussion of difficult issues. This is proving to be effective and producing settlements, even in one case where the result involved a degree of double taxation for the taxpayer. All transfer pricing audits are done by the 12-member transfer pricing team.

Where a clear timetable for the enquiry has been set or agreed, any deviation from that should be signalled in advance and any necessary changes to the timetable made clear. If the case is subject to an internal process within the tax administration that may take some time, this should be explained to the business and they should be kept informed about progress. Similarly, the business should be asked to be open about progress in dealing with any requests for information or documents that are taking some time to collate.

Some tax administrations are increasingly looking to develop enhanced relationships with their large business customers. For example, in the Netherlands this is known as horizontal monitoring, which was piloted in the very large business segment and is now a well established programme that has been extended to other customer groups. Taxpayers who are willing to take part in the programme and whose profile is suitable enter into a formal agreement with the Netherlands Tax and Customs Administration. An important element is the existence or establishment of a tax control framework which ensures early knowledge about tax risks; in large cases the tax control framework will encompass transfer pricing issues. Horizontal monitoring is based on three key values: mutual trust, understanding and transparency. Transparency means that there is complete openness between the taxpayers and the tax administration. The taxpayer is transparent about their tax strategy and the relevant tax issues, including transfer pricing issues. Filed tax returns do not adopt standpoints on material issues that have not been discussed with the tax administration in advance. This approach enables discussion about difficult issues, including transfer pricing risks, up front and much closer to the time when the transactions are executed, that is to say in 'real time'.

Role of advisors

Whilst some tax administrations felt that the involvement of advisors could, at times, hinder engagement with business and therefore slow down the progress of a transfer pricing case, others recognised the positive role that advisers could play in facilitating engagement and dialogue between business and the tax administrations. A number of tax administrations gave examples of where advisers had been constructive in persuading business to take a more reasonable view of the tax administrations' contentions.

One novel example of how advisors had supported positive engagement and facilitated progress was provided by the UK.

Box 9. United Kingdom – an example of constructive facilitation by advisors – joint modelling

In a major transfer pricing case, both HMRC and an MNE realised that there was a high degree of agreement about the appropriate pricing model, even though there was substantial disagreement about the appropriate inputs. In fact it was quickly recognised that each side's pricing model, although built on the advice of different experts, could actually be stripped back to a point where the models were almost identical. The MNE's advisers worked with the MNE and HMRC to develop a single agreed model. Following rigorous testing by specialists in HMRC, this model sat in a data room in the offices of the MNE's advisers but with access provided to all parties. HMRC and the MNE agreed to use this single model for all their hypothetical thinking and to test the impact in tax terms of agreed changes and of the range of differing inputs under consideration. Both sides met daily for a two week period of intense discussions. The joint model allowed them to focus on the key issues and reach a mutually acceptable outcome. Working in this way was extremely productive and saved all parties substantial time and cost.

Use of specialists

The type of specialists who can add value to transfer pricing cases, their role and the timing of their use is covered in detail in Chapter 7. No mention of progressing transfer pricing cases and tackling delay would, however, be complete without reference to the value that specialists, in particular sector experts (as mentioned in *Chapter 3*), valuation professionals or economists, can add at this stage. In the HMRC example given above in Box 9, the joint model, which proved so fundamental to resolution of this long running dispute, was developed and tested by expert economists. In those tax administrations which have the ability to bring in either internal or external expertise, experience suggests that they can be particularly effective in helping to reopen the dialogue in cases where progress has stalled.

Monitoring progress and active management

The importance of a project management approach including clear project plans for transfer pricing enquiries based on a rigorous and focused examination of the risks, often in the context of a robust governance structure, was highlighted in Chapter 3 as key to getting off to a good start. An appropriate system of oversight of such project plans, to ensure problems are quickly identified, as well as methods for effectively addressing problems as they arise, were identified by tax administrations and advisors as key to tackling delay. The more complex the case, the more crucial it is to maintain momentum, given the time that can be wasted repeating and revisiting the facts as team members on all sides change over time.

Oversight of project plans

Consideration of the merits of an audit or enquiry by senior management before it is entered into is considered good practice. In the UK for example, every transfer pricing enquiry must be opened with prior approval of the Transfer Pricing Panel or Board and an action plan produced. Those action plans are reviewed regularly. The box below sets out an extract from HMRC instructions to those working transfer pricing cases:

Box 10. United Kingdom - action plan reviews

To help ensure that a transfer pricing enquiry progresses in accordance with the Action Plan, a formal review must be undertaken at regular intervals but at a minimum of every six months. The review is recorded on the same template used from the start of the enquiry and must be submitted to the appropriate Transfer Pricing Panel. The review should contain:

- a summary of progress since the start of the enquiry (or the last review) details of any factors inhibiting progress and what has been/will be done to counteract them
- a brief résumé of what further work the team intends to carry out
- an assessment of whether the enquiry is likely to settle according to the original timetable set out in the Action Plan and, if not, what revision is required (including an explanation)
- a re-evaluation of the tax at risk, and a statement regarding the penalty position.

In the UK, HMRC's governance process ensures that robust management information is held on the age of all transfer pricing cases. Whilst the Transfer Pricing panels consider individual cases and provide management challenge to those leading the enquiries, the Transfer Pricing Board regularly reviews the overall progress against HMRC's targets for resolving transfer pricing cases. Where problems are identified it will consider issues such as redeployment of resource and training and development needs and, more recently the role that Alternative Dispute Resolution (ADR) can play in moving to resolution.

Alternative dispute resolution

Business, their advisers and tax administrators all told the study team that parties to transfer pricing disputes can become so deeply entrenched on issues that little progress to resolution is made over months or even years. Tax administrations have recognised that this type of deadlock can arise in a range of different types of tax dispute and HMRC has recently been looking at piloting Alternative Dispute Resolution (ADR), using mediators, in a small number of cases and it has reviewed some transfer pricing cases that were "sticking" to see whether they might be suitable candidates. But every time HMRC has looked more closely, it has realised that what is needed is something far more simple – a reassessment of the case, proper consideration of its merits or otherwise using a fresh pair of eyes and a reinvigorated action plan developed jointly with the business. In every case considered so far, that is all that has been needed to progress the case further. This reinforces the case for explicit governance of transfer pricing cases of the kind that is discussed in Chapter 4. However, some cases may not be capable of resolution in this way. Recognising this, the study team has looked at a technique commonly used in alternative dispute resolution for non-tax issues – Early Neutral Evaluation.

Early Neutral Evaluation (ENE) is the preliminary assessment of the contentions of the parties to a dispute by an independent and impartial person appointed (and paid) by both parties. Each party's assertions are assessed on their facts, supporting evidence and legal arguments by the neutral evaluator who then expresses a view on the merits of each case. The process is usually conducted by a lawyer, retired judge or other expert person and is designed to provide a basis for further negotiations, or at least help the parties avoid more formal (and often highly expensive) dispute resolution processes – such as litigation. It is a non-binding process that provides an unbiased evaluation of the relative strengths of each party's position and gives guidance on the likely outcome should the dispute proceed further without a significant change in approach by one or both parties. The Technology Court in the

United Kingdom requires parties to go through a process such as ENE before litigation can actually start. In certain circumstances a judge may oversee the process.

There are advantages and disadvantages to Early Neutral Evaluation.

- Some advantages are:
  - An obstacle to settlement can be swiftly removed.
  - The evaluation is generally made "without prejudice" and therefore not binding.
- Some disadvantages are:
  - One party's bargaining power may be reduced by an unfavourable evaluation.
  - There is no guarantee that if litigation does eventually take place the judge(s) will not take a view different to that of the evaluator.

Business and administrators alike were interested in exploring further whether and how ENE could be used or adapted for transfer pricing cases, particularly in reaching agreement that sufficient facts and evidence had been provided or obtained. This is of relevance to findings in Chapter 6 where one of the key challenges to reaching a decision point is knowing when the time to stop fact finding has been reached. Some business leaders saw potential advantages in some form of ENE in circumstances where they felt they had provided all necessary material to facilitate a transfer pricing enquiry and still a tax administration wanted more. Some tax administrations wondered whether the technique might be useful where they had laid out a case to answer but the business and its advisers were focusing more on legal issues than providing essential evidence. Business and tax administrations wondered whether some form of ENE might be of use in avoiding the cost of litigation. Overall the technique would appear to have relevance to transfer pricing and is an approach tax administrations may want to consider using in cases that have stalled.

In some circumstances a Court may oversee an alternative approach to resolution of a transfer pricing dispute. For example, following reform of the tribunals system in the UK, the First Tier Tax Tribunal (the first level tax court) is required by its Rules to bring to the attention of the parties to a dispute the availability of any appropriate alternative procedure for the resolution of the dispute. If the parties are willing, the Tribunal can also facilitate the use of an alternative procedure providing that it is compatible with the overriding objective of dealing with cases fairly and justly. It follows that the Tribunal can, for example, oversee an approach to the settlement of a transfer pricing dispute without actually hearing an appeal against an assessment.

Internal appeals process

Where they exist, established internal appeals processes can help to unblock cases. A number of tax administrations do have an internal appeals function, although the stage at which they are used, and the level of independence of those involved does vary. Some examples are discussed in Chapter 6.

Operational guidance

Tax administrations take different approaches to the amount of operational guidance that they make available to business and their advisors but all emphasised the importance of ensuring it is consistent with the law and up to date. Some felt that it was helpful to ensure that business and

advisors knew what to expect from the tax administration and publication could help demonstrate consistency of approach and therefore support actions taken by the tax administration. Tax administrations, business and their advisors noted that where guidance is published it can be very helpful, both to business and the tax administration, to consult with external stakeholders whilst the guidance is still in draft so that issues or concerns can be addressed by the tax administration before the guidance is finalised, usually leading to a much better product.

Deliberate obstruction

Most tax administrations recognise the need to regularly reassess the scope of their audits and enquiries to ensure that they remain relevant. In a similar way they need to ensure the reasonableness of their requests, particularly where they set tight deadlines. However, sometimes despite all efforts to do this and engage with a business, tax administrations can be faced with outright opposition to their attempts to undertake an audit or enquiry. Where this happens they need to have ready strategies that can be deployed to counter such obstruction; for many tax administrations this can involve the use of information powers, the ability to estimate assessments and to close cases using legal processes. Having the ability to use all of the means of tackling delay outlined in this chapter should, however, mean that these are only strategies of last resort and seldom need to be used.

Key thoughts for chapter

Most tax administrations have experience of transfer pricing audits or enquiries that run for many years. Often the cause of delay lies in the fact intensive nature of transfer pricing work and disagreements over the provision of business records. Early discussion about the aspects of the business to be reviewed, carefully focused requests for records and agreed timetabling can ensure a speedy and effective outcome to audits or enquiries. The development of alternative dispute resolution techniques in several countries suggest that this approach may be of use in transfer pricing cases.

Chapter 6

Reaching a decision point

This chapter considers the closing stages of an audit or enquiry and the process of deciding the final outcome. In particular it looks at the way in which decisions to settle or litigate are reached, the process of negotiation, the role of an internal appeals function and litigation.

Tax administrations, business and advisers alike recognise that the big question in many transfer pricing audits and enquiries, particularly the most complicated, is when has the time come to stop fact finding and conclude the enquiry, whether by means of negotiation, or through litigation if that is necessary. This decision cannot be taken lightly because significant amounts of money can be at stake and the cost of litigation can be enormous. The value of good governance of transfer pricing work has been discussed already but it is particularly relevant when cases reach this critical stage. It is important that the decision is seen to be the result of an objective process and not influenced by subjective or inappropriate considerations. This chapter explores the issues tax administrations need to consider when concluding a transfer pricing audit or enquiry.

Whether to litigate or negotiate

Different countries approach this issue in different ways. Some countries publish strategies explaining how they make the decision whether or not to litigate in civil tax disputes. In the UK, for example, the Litigation and Settlement Strategy ("the Strategy") is the framework within which HMRC seeks to resolve disputes through civil procedures:

- consistently with the law, whether by agreement with the taxpayer or through litigation; and
- consistently with HMRC's customer-centric business strategy objectives of maximising revenues flows whilst at the same time reducing costs for all and improving taxpayer experience.

The Strategy was introduced in 2007 and refreshed in 2011. It has been widely published outside HMRC and is well understood in the tax advisor community.[1]

Within HMRC the Strategy serves to focus the minds of auditors and inspectors on the importance of having clear plans for their enquiries and on the need for regular reviews of the strength of their arguments.

Box 11. United Kingdom's Litigation and Settlement Strategy

- The Strategy sets out the principles within which HMRC handles all disputes about any taxes or duties where those disputes are subject to civil law procedures, and whether disputes are resolved by agreement with the taxpayer or through litigation. This includes most of HMRC's compliance activity.

- The two key elements of HMRC's approach to tax disputes are:

  - supporting taxpayers to get their tax right first time, so preventing a dispute arising in the first place; and:

  - resolving those disputes which do arise in a way which establishes the right tax due at the least cost to HMRC and to its customers, which in most cases will involve working collaboratively.

- The LSS encourages HMRC staff to:

  - minimise the scope for disputes and seek non-confrontational solutions;

  - base case selection and handling on what best closes the tax gap;

  - resolve tax disputes consistently with HMRC's considered view of the law;

  - subject to that, handle and resolve disputes cost effectively – based on the wider impact or value of cases across the tax system and across HMRC's customer base;

  - ensure that the revenue flows potentially involved make any dispute worthwhile;

  - (in cases where HMRC's position is strong) settle for the full amount HMRC believes the Tribunal or Courts would determine, or, where that is not possible, litigate;

  - (in cases where there is no scope for compromise, for example where the facts are agreed and the question is whether the law applies in a particular way) not split the difference;

  - (in weak or non-worthwhile cases) concede rather than pursue.

In appropriate cases, Alternative Dispute Resolution (ADR), and more specifically mediation, can help HMRC and its customers resolve disputes in a cost effective and efficient manner.

In a number of countries there is an internal appeals process that can be invoked before a case goes to formal litigation in the Courts. These processes can help to achieve agreed settlements in cases. The appeals systems used in Japan and the US are described below.

Governance of decisions to litigate or settle

To support its Strategy set out in Box 11**,** HMRC has governance processes for all significant decisions about settlement and litigation. Those processes have recently been endorsed by the UK's National Audit Office.[2]

In broad terms, all cases and/or issues with tax at risk in excess of 100 million GBP must be considered by the High Risk Corporate Programme (HRCP) Board which is chaired by the Director of the Large Business Service (LBS) and consists of directors of other key parts of the Department.

Where transfer pricing issues meet the above criteria they are considered by the HRCP Board on the basis of recommendations made by the Transfer Pricing Board. Where transfer pricing issues do not meet the criteria mentioned above, decisions are referred to the Transfer Pricing Board either by the case team or by the Transfer Pricing Panel for the LBS or the Panel covering all the other areas of HMRC undertaking this work. The Board makes the final decision on cases where litigation is proposed by a Panel and agrees settlement parameters in high value cases below the threshold for submission to the HRCP Board.

In many tax administrations processes for deciding whether or not to litigate require decision taking to be made by individuals who have not been directly involved in working or managing the audit or enquiry. A written submission is normally required setting out:

- the position of the parties,
- a recommendation from the most senior manager with oversight of the audit or enquiry,
- an assessment of whether penalties could be sought if the case is won.

The key issues in deciding whether or not to litigate are likely to be some or all of the following:

- From the tax administration perspective, do a transfer pricing specialist and a litigation lawyer agree that the case is a strong one that can be won?
- Is a significant amount of tax at stake?
- Have all attempts to negotiate a reasonable settlement failed?
- Is the case likely to be the subject of consultation under the Mutual Agreement Procedure provided for in a double taxation agreement?
- Is there evidence of good quality to support the tax administration's arguments and has that evidence been proved (can someone speak authoritatively to the source of the evidence) and properly examined by lawyers and specialists?
- Are expert witnesses needed and, if so, what are they going to speak to? Has their evidence been fully tested?
  - Could the time and money costs of litigation outweigh the benefits of success?
  - Do legal precedents support the tax administration's position?

In the UK the answer "No" to any one of the above questions may lead to a decision that litigation is inappropriate and that further negotiation or a form of alternative dispute resolution would be more appropriate. In the UK, HMRC does not litigate speculatively and if on balance the case is likely to be lost in litigation, it will not be pursued.

In HMRC the governance process for decision making in Transfer Pricing cases requires a referral, in the first instance to the Transfer Pricing Panel before a decision is taken as to how the case should be concluded.

Box 12. United Kingdom – HMRC's guidance to staff on decision making in Transfer Pricing cases - requirement for a referral

- The referral is by means of a written review of the case by the case team/Transfer Pricing Specialist.
- The review should be recorded on the same template used from the start of the enquiry and additional guidance on its completion is available on the Transfer Pricing Group Intranet site.
- The completed review should be sent to the appropriate Transfer Pricing Panel as soon as possible and leaving adequate time to complete the process of resolution itself within the overall 18/36 month time limit.
- The Transfer Pricing Panel should not be presented with a recommendation to litigate until a Head Office Transfer Pricing Specialist and Solicitor's Office have given at least an indicative opinion on whether litigation steps should be taken.
- Taking full account of the resolution review recommendation, the Transfer Pricing Panel (in larger cases the Transfer Pricing Board or, in the very largest cases, Excom[3]) will decide whether the case team should negotiate a settlement.
- Where the decision is to negotiate, the Transfer Pricing Panel etc. will authorise the case team/transfer pricing specialist to settle according to clearly defined parameters.

Settling disputes by negotiation and the role of internal appeals

A number of tax administrations encourage resolution of disputes by negotiation in order to avoid the uncertainty of outcome, time delay and costs of litigation. Even where there is a clear strategy and tight governance around reaching the conclusion whether or not to negotiate or litigate, some tax administrations have processes in place to encourage settlement other than by litigation.

In the US to minimise the expenditure of resources by the taxpayer and tax administration alike, the IRS encourages taxpayers to resolve their disputes by negotiation and settlement rather than by litigation. This sort of dispute resolution in the IRS is by appeal to the Office of Appeals ("Appeals"). Appeals can resolve disputes because it is the only administrative function the IRS with the authority to consider the settlement of tax controversies and is charged with resolving, to the maximum extent possible, disputes without resorting to litigation. Appeals have to resolve disputes without litigation on a basis which is fair to both taxpayer and Government and which will enhance voluntary compliance. US tax lawyers told the study team that they aimed to get their transfer pricing cases to Appeals at the earliest possible point in an audit or enquiry so that a process of negotiation could begin. They did not regard the Appeals' process as particularly easy to navigate. Nonetheless, the Appeals function is very successful in settling tens, if not hundreds, of thousands of cases of all types a year with a success rate in excess of 80% of the cases referred to them.

It is interesting to note that the statutory provision that allows taxpayers to recover costs from the IRS when they succeed in litigation, requires the taxpayer to have exhausted every legal remedy before litigating. This means that a taxpayer will normally have had to refer their issue to Appeals before going to Court.

Appeals' authority to resolve tax disputes without litigation derives from their ability to reach settlements on the basis of an assessment of the hazards of litigation.

Box 13. IRS Statement of Procedural Rules for Appeals

Appeals will ordinarily give consideration to an offer to settle a tax controversy on a basis which fairly reflects the relative merits of the opposing views in the light of the hazards which would exist if the case were litigated **… [a fair and impartial resolution is one that]** reflects on an issue-by-issue basis the probable result in the event of litigation, or one that reflects mutual concessions for the purpose of settlement based on the relative strength of the opposing positions where there is a substantial uncertainty of the result in the event of litigation.

Not every case referred to Appeals can be settled. For example, settlement is not permitted unless the taxpayer is able to demonstrate there is real uncertainty in law or fact or both as to the correct application of the relevant law to the case. Appeals focus on the evidence available in a case and have to assess the law that applies to an issue. They must consider any settlement proposal demonstrating a good faith attempt to resolve the case.

Where there is a dispute between the business and the National Tax Administration (NTA) in Japan there is a clear process which allows for a review of the assessment, both at examiner level and subsequently by the National Tax Tribunal, before an appeal goes to formal litigation as explained in Box 14.

Box 14. Japan – NTA: Reinvestigation and Reconsideration before Litigation

When the tax authorities (*i.e*. District Director, Regional Commissioner of the Regional Taxation Bureau) do a disposition for taxation and taxpayers object to that disposition, taxpayers can use the following remedy during a certain period. There is no procedure in Japan such as negotiated resolution between tax authority and taxpayers.

– Request for reinvestigation

A request for reinvestigation is the first stage in administrative appeal with regard to national taxes. In cases where tax authorities took action for a correction, determination or seizure, with which taxpayers are dissatisfied, taxpayers can request the tax authorities to revoke or change the ruling, within two months from the date when the decision by tax authorities was made.

– Request for reconsideration

Taxpayers, who remain dissatisfied with the decision made following the request for reinvestigation above, are entitled to file a request for reconsideration to the Director-General of the National Tax Tribunal, within 1 month from the date when the decision of reinvestigation was made.

– Litigation

Taxpayers, who remain dissatisfied with the decision by the Director-General of the National Tax Tribunal, are entitled to file litigation with the judiciary seeking a legal remedy, within six months of the date when the decision by the Director- General of the National Tax Tribunal was made.

Settling disputes by litigation

The costs of litigating a transfer pricing case can quickly become out of proportion to the tax in dispute and even where that is not so they can still be huge.

Across the world, transfer pricing disputes are said to be very difficult to litigate. As was observed in the introduction, they are fact intensive and they require expert evidence on business sectors and pricing strategies. Litigation will usually also involve specialist tax evidence and testimony from one or more economists. When in 2007 HMRC officials interviewed judges in a number of countries who regularly hear tax disputes in Court, the commonly expressed view was that transfer pricing cases should not be litigated unless one side or other had a compelling case. Without there being a compelling case, these judges said that they would generally be inclined to split cases down the middle. A tax law seminar recently organised in the UK to consider the issue of transfer pricing dispute reached a similar view – transfer pricing cases should be capable of a negotiated settlement where all relevant facts were on the table, but if litigation proved necessary the relevant tribunal or Court should take firm control of the process and where appropriate restrict the number of expert witnesses and take other steps to make the judicial process manageable.

Key thoughts for the chapter

The most difficult decision to be taken in many transfer pricing audits or enquiries is often when to stop fact finding and bring the case to a conclusion. Business and governments alike need to have confidence in the procedures by which that stage is reached and in how the decision of whether to negotiate a settlement or litigate is taken. Well understood and objective procedures with good governance are essential.

Notes

1 http://www.hmrc.gov.uk/practitioners/lss.pdf

2 An independent Parliamentary body responsible for auditing government departments, etc.

3 The Executive Committee (ExCom) is the executive decision making body for HMRC. The Committee oversees all of HMRC's work.

Chapter 7

Resources, skills and use of specialists

Transfer pricing work is a specialism in its own right and complex cases will often require input from experts in other specialist fields as well. This chapter discusses how tax administrations can best manage and develop the skills and knowledge needed to run effective transfer pricing programmes. It also looks at ways in which the work can be organised.

Tax administrations around the world told the study team that they face many common administrative challenges in tackling transfer pricing, even though they may address them in different ways. This chapter identifies some of those key challenges, a number of which are interlinked, and describes some of the solutions deployed by tax administrations.

Resources

Major accounting and law firms generally have all the expertise necessary to handle transfer pricing cases and are able to deploy that resource flexibly. If a case is significant the taxpayer, or its advisor, will usually buy in any resource not already available to them. Tax administrations are usually much more constrained when it comes to resources. A tax administration can be stretched by the complexity and volume of cases it has to tackle at any particular time, its people will frequently have less relevant industry knowledge and may lack the skills and experience of specialists in the major tax firms focused only on transfer pricing. Many tax administrations have said that they lose experienced transfer pricing specialists to the private sector for significantly increased salaries and therefore face the constant challenge of needing to renew and re-skill their teams. This makes it harder for tax administrations to deploy sufficient skilled people to progress cases as rapidly as they would like. As a result the efficient organisation of transfer pricing work and effective knowledge management are particularly important.

Knowledge management

Knowledge management in transfer pricing often works better in the private sector than in tax administrations. There are two crucial aspects to this; maintaining and sharing relevant precedent, and capturing learning from individual cases. Poor knowledge management can impact negatively on every stage of the audit or enquiry process: it can hinder effective identification of risks, lead to delay and can substantially weaken the position of tax administration negotiators at conclusion of the case. Many tax administrations have to balance the benefits of sharing learning from individual cases more widely with colleagues with the need to preserve taxpayer confidentiality and restrict details of individual cases whilst at the same time as sharing the principles.

Effective governance of transfer pricing work also helps to create the conditions for good knowledge management. Senior managers are aware of the most significant cases and are able to ensure consistency of treatment when cases come to settlement. The governance process naturally supports the collection and maintenance of records of how cases have been settled and ensures that this information is shared among the key decisions makers. Even the smaller cases will have been reviewed by more than one person, which also encourages knowledge sharing and consistency. In administrations that track all their transfer pricing enquiries centrally, knowledge management is catching up with best practice in the private sector and oversight of the work is actually more effective than in some large advisory firms.

Training

Tax administrations recognise the difficulty of developing and maintaining their professional knowledge and experience. Particular challenges include losing expertise, either as transfer pricing experts move to the private sector, or as a result of the normal turnover of staff within the organisation; managing training programmes which can compete with those of the private sector, whilst facing different cost constraints; and simply keeping up with fast moving developments in the commercial world.

Complexity

A number of tax administrations considered that transfer pricing, although it is a far from straightforward subject, can become unnecessarily complicated when, for example, engagement with advisers leads to excessive analysis of perceived legal issues, premature legal argument, deployment of specialists and experts before they are needed, and generally unfocused economic analysis. Some suggested that this risked creating a mystique around transfer pricing work which could deter developing countries from taking up cases, hinder more developed countries, and could increase the costs for all. Those who raised this concern recognised that tax administrations, advisors and business alike all played their part in contributing to this perceived over-complication.

Resources and skills – solutions

Resources, knowledge management and training

One of the ways in which tax administrations tackle some of the challenges outlined above lies in the organisation of their in-house resource. Tax administrations tend to organise their transfer pricing work in line with one of two broad business models. The first model is based on specialist teams who undertake the end to end process of transfer pricing – from risk identification through to resolution of audits and enquiries.

South Africa, for example, is presently building an international tax team of up to 40 people which will handle transfer pricing in this way. This model allows significant expertise to be built up and maintained but it does not grow across the tax administration a broad base of knowledge and skills in relation to transfer pricing risk.

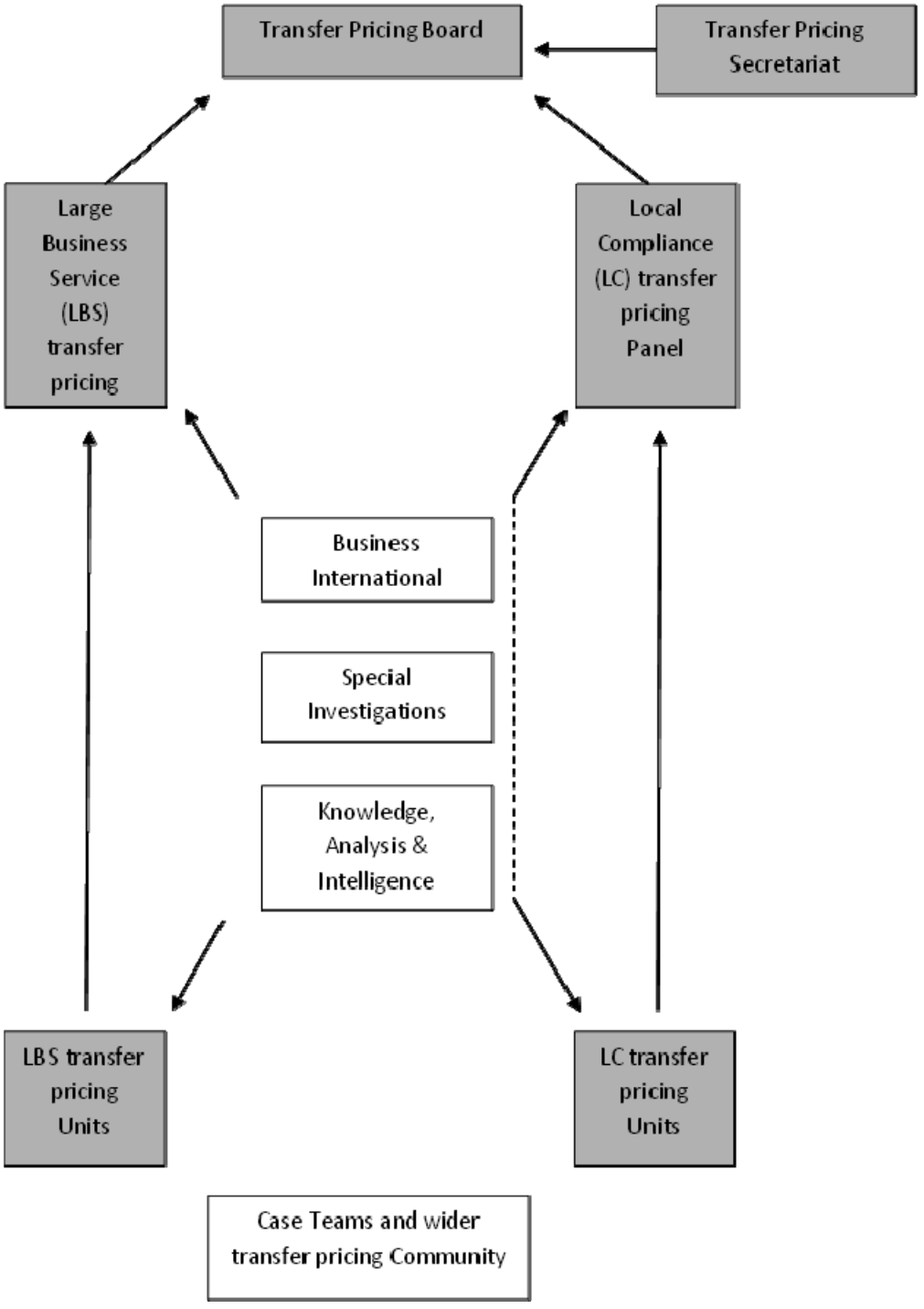
An alternative model involves creating a specialist function at the centre of the tax administration to support and advise auditors and inspectors how best to address the technical issues arising on their transfer pricing cases. It is rare for these specialists to work cases themselves but that can happen when issues are particularly novel or contentious. The advantage of this approach is that transfer pricing risk is identified alongside other tax risks by auditors and inspectors with the greatest knowledge of the business. This approach also allows for greater flexibility in resource deployment.

A number of tax administrations combine the approaches in a range of ways. In the UK, for example, there is a central specialist advisory team on transfer pricing who do not generally lead on audits or enquiries. The UK also has a number of specialists within its LBS who share their experience of working transfer pricing cases with auditors and inspectors managing tax risk on a day to day basis. Leadership on transfer pricing and all other tax risk dealt with in the LBS is provided by the Customer Relationship Manager (CRM) accountable for the tax compliance of individual large businesses.

The OECD sponsored multilateral training programmes offer an innovative approach to training in this area and one that helps to foster a common understanding of the issues among tax administrators from different countries.

Box 15. UK – HMRC's organisation of Transfer Pricing work

- HMRC organises **and** carries out its transfer pricing enquiry work through its Transfer Pricing Group which is structured as follows:



Source: HM Revenue and Customs

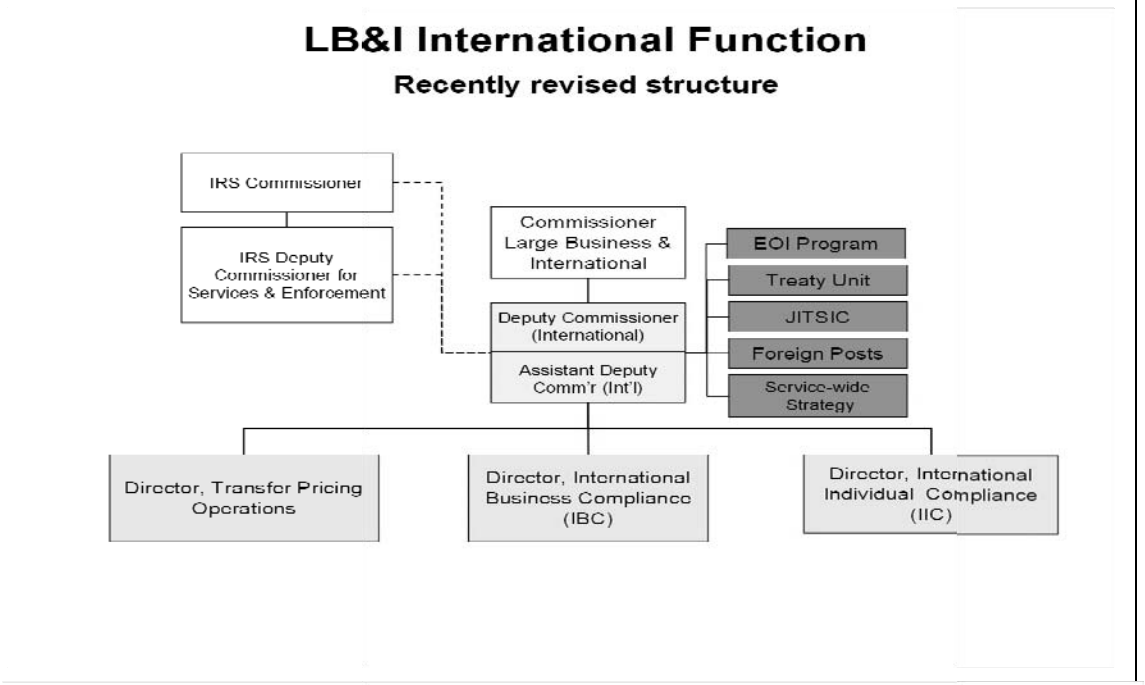
- The **transfer pricing units** assist the case teams responsible for the tax compliance of a particular business in:
  - assessing the transfer pricing risk
  - where appropriate, making a report to the relevant transfer pricing panel recommending that an enquiry be undertaken into the transfer pricing of the business
  - assisting in the subsequent enquiry
- The transfer **pricing panels** approve operational decisions as to:
  - whether to open a transfer pricing enquiry
  - how a transfer pricing enquiry should be settled, *e.g*. by negotiation or settlement
  - the parameters within which case teams may settle where negotiation is appropriate
- The transfer **pricing board**:
  - sets the strategic direction of the Transfer Pricing Group
  - approves operational decision-making on higher risk cases
- There are, additionally, three specialist units available to provide guidance and support to the case teams and who have representation on the Panels:
  - **Business International** which has overall policy responsibility for the UK's transfer pricing legislation and provides specialist advice and training in respect of the application of that legislation. It also provides support and advice in respect of the risk assessment, undertaking and progressing of transfer pricing cases. This can include attendance at meetings with the business and its representatives. Business International also has responsibility for the APA and FMAP processes.
  - **Specialist Investigations** which provides experience in document examination, interviewing of personnel, negotiation and litigation.

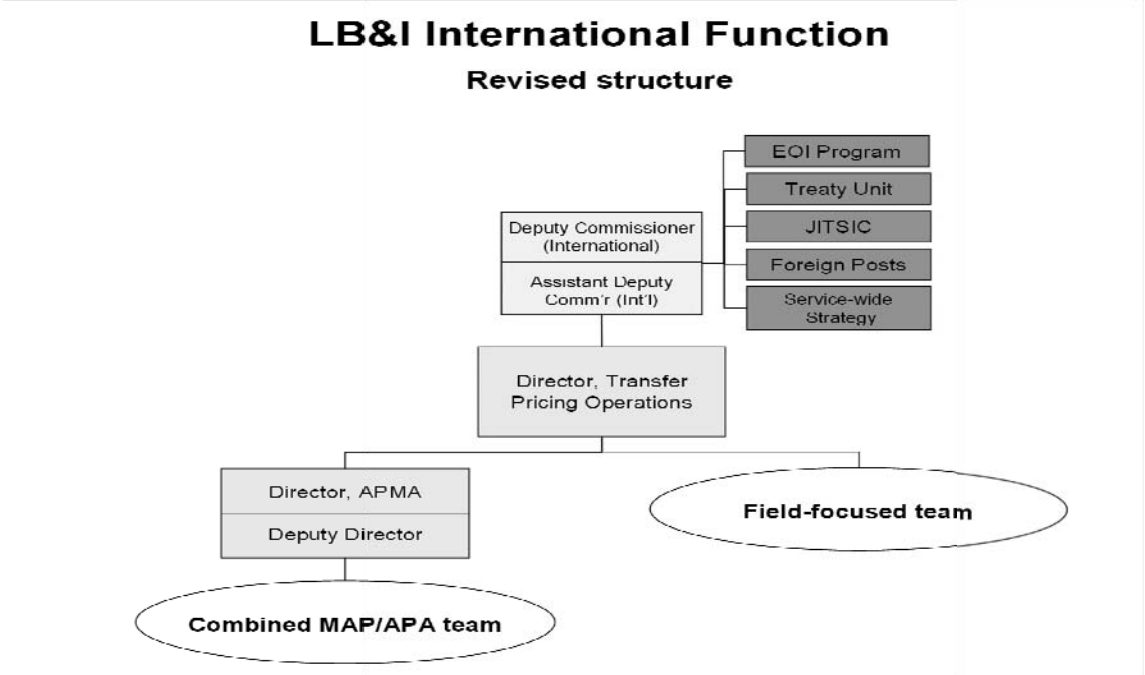
Knowledge, Analysis and Intelligence which provides specialist input from economists when necessary.

Many tax administrations found that a structural model which includes some form of centralisation or specialisation can assist in providing more effective and efficient training to staff and in maintaining and developing knowledge management. The training needs of a smaller group can be more carefully identified and more easily and cheaply met. In addition some tax administrations have developed new ways to deliver training that retain the face to face element but reduce the need for travel costs.

In the US the Internal Revenue Service (IRS) has recently reorganised its international work. International examiners and economists will continue to work with colleagues in the field as members of a broader team but they are now managed as a cohort of specialists. There were a number of drivers behind the change. In part it was a response to the growing importance and complexity of international issues and transfer pricing in particular that was discussed in the introduction. The advisory firms that the IRS deals with commonly have specialist teams dealing with international issues and the IRS needs to match their levels of experience and expertise. Creating a national team of international specialists also makes it easier to deploy resources where they are most needed. This was harder when specialists were part of regionally defined teams as transfer pricing risks are not evenly distributed across the country. And improving the training and development of international examiners and economists is another key objective for the new organisation.

Box 16. Large Business and International in the IRS





Source: Internal Revenue Service (IRS)

Many of the Big 4 advisors recognised the training challenges faced by tax administrations and considered it was in their interests and those of their clients for tax administrations to develop and maintain a high level of skill. In their view a highly skilled tax administration ensured that audits and enquiries were well targeted and progressed quickly. This challenged the view that advisers could at times seem keen to exploit weaknesses. In particular advisors and business were keen to support tax

administrations in developing greater the level of commercial awareness required for effective transfer pricing audits and enquiries.

In the UK, for example, HMRC has arranged events with a wide range of external speakers to cover global trading and the tax issues that can arise. For example, a group of senior tax specialists have been working with tax partners in a Big 4 firm to promote increased understanding of how cross-border transactions are structured, the tax issues which can arise and how HMRC is likely to react. Similarly, HMRC has good working relations with most of the transfer pricing teams in major accounting firms and regularly meets with them to discuss matters of mutual interest.

The way transfer pricing work is organised in tax administrations usually reflects different national contexts. A degree of specialisation is common, but can vary from country to country. Some tax administrations have developed training packages designed to give generalist auditors a broad awareness of transfer pricing issues and the ability to spot key transfer pricing risks in their day to day dealings with the businesses they are responsible for, while others have identified a need to bring in external specialists in one form or another.

Complexity

Transfer pricing is undoubtedly a complex technical issue for all tax administrations requiring highly trained staff and specialist skills. However, tax administrations which are most successful in addressing transfer pricing issues are those which treat transfer pricing work not only as a specialist subject but also as a mainstream compliance activity. To do this they embed transfer pricing in their overall strategies for large business, compliance, governance and audit and enquiry handling. As a result transfer pricing work can be addressed using existing, well established compliance processes so that scarce specialist resource can be focused on the aspects of transfer pricing that require it.

The Role of Specialists

There is wide agreement that transfer pricing is a specialism in its own right. It involves not just the need to understand the applicable domestic law, relevant treaty provisions and the OECD's Transfer Pricing Guidelines, but also the need to make an economic assessment as to whether transactions are on commercial terms. In addition, although pricing issues can have a big impact on tax liabilities, they are not generally a routine area of training and development for tax officials.

The following paragraphs in this chapter are, however, concerned with the use of specialists from disciplines other than taxation, particularly economists and business experts.

Types of specialists

Different types of specialists can all play a significant part in transfer pricing audits and enquiries. The UK tax administration, for example, has:

- established a network of experienced trade sector advisors inside the organisation, with deep understanding of business, who have been recruited from the private sector with commercial rather than tax backgrounds. They provide insights into the environment within which a range of businesses exist and promote understanding of how businesses operate in practice. Often, their approach is to provide industry reports for less knowledgeable colleagues, as well as being available to work on aspects of specific cases

- engaged on a consultancy basis private sector industry experts and specialist economists to advise on specific high profile and/or high risk cases as difficult issues have arisen.

- used the UK's Government Actuary Department because of their expertise on pricing returns on capital.

How to engage with external specialists

The decision about whether to retain external specialists to provide bespoke advice on particular issues or to recruit specialists from the private sector as employees of a tax administration can be a difficult one. Where experts are independent of the administration, they are able to provide an unbiased view about how transactions differ from those that would have taken place at arm's length. They command authority and have either first-hand commercial experience, or experience of advising in commercial assignments, to help formulate rigorous arguments, supported by reference to academic studies and theories. Many have considerable experience as expert witnesses and are consequently skilled in framing forensic arguments clearly and precisely, and in bringing resolution to disputes. It should also be noted that external experts are generally dependent on their success in past assignments in order to attract new work and this can be a powerful incentive for them to deliver outstanding performance.

What external specialists can deliver

Importantly experts can help focus interventions on the key risks and issues and assist in framing information requests. For example, they are often able to advise, from personal experience, precisely what documentation should be available to bring out key facts. This is invaluable in helping to focus in on those key issues and scope out areas of dispute to provide added credibility to the administration's engagement on an issue. The experience in South Africa of using external experts to support the preparation of transfer pricing cases and give evidence in court has been very successful. However, SARS has also found that industry experts can sometimes be reluctant to help a tax administration, whether in the context of conducting audits and enquiries, or in litigation, if those experts have an expectation of other pricing work, perhaps elsewhere in their area of expertise.

Selecting the specialist

In selecting experts it is important to find individuals who can explain technical issues in ordinary language and who, where relevant, are articulate and persuasive in court. Both HMRC and SARS have also found that in transfer pricing cases commercial litigators are often more effective than tax litigators. Transfer pricing cases are very fact dependant and commercial litigators are more experienced in drawing out factual evidence in cross-examination. In Denmark, SKAT is now permitted to make more and more use of the private tax legal advisors that acts as counsel of the State. It is SKAT's experience that the additional costs that may be incurred are balanced by the help received in deciding matters of principal and preparing transfer pricing cases for court.

Knowledge and skills transfer from specialists

Ensuring transfer of knowledge and skills from external experts to tax administration staff working transfer pricing cases can be more challenging as these experts often tend to focus principally on ensuring the success of their assignment. Recruiting specialists and/or experts as employees is generally a more successful way of delivering transfer of knowledge and skills and this is best done by enabling them to play a part in the work of several teams at the same time. Whilst in house experts and specialists can be successful as expert witnesses in litigation or in hearings connected with processes for alternative dispute resolution, over time they become increasingly detached from specific industry developments and knowledge and therefore lose some expertise. That can mean they become less able to make a meaningful contribution on individual cases.

Managing the engagement of external specialists

Tax administrations that bring in external experts to advise and provide expert evidence on a particular case have to monitor three issues very carefully. First, external experts can be very expensive – some tax administrations have run up costs equal to several million US dollars in bringing in an expert; where more than one expert is needed the costs can rise very quickly. Sometimes there can be a risk that costs suddenly and unexpectedly exceed the planned benefits from a case.

Second, an external expert can often be the crucial witness in a transfer pricing case. Judges who have been prepared to discuss their approach to contentious transfer pricing cases have said that an expert witness can bring arguments to life and will often be the one witness to whom they pay the most attention. It is, of course, vital for a tax administration to be able to assess the strength of its case and that will often mean having a very clear understanding of the nature and likely weight of expert evidence. It is, therefore, important for tax administrations to understand the extent to which an external expert has developed novel or contentious arguments for use in litigation and to gain an appreciation of how those arguments will play with a Court.

Third, the largest and most complex transfer pricing cases can involve a number of external experts on each side, particularly when it comes to litigation. Both advice provided and the expert evidence to be given in litigation can become confusing in these circumstances. Tax officials and lawyers may be unable to decide easily which expert evidence to follow and how best to develop their arguments. In HMRC's experience, this risk is often best met by having an in-house economist who can evaluate the advice and evidence on offer. An alternative approach is to ask a tax court or tribunal to agree that each party to litigation can use only one expert witness.

Tax administration perceptions of specialists

Sometimes tax administration auditors need to be convinced of the value of non-tax specialists. For example, in some instances auditors have challenged the need to involve non-tax specialists, such as economists, arguing that it would be preferable to provide tax auditors with the necessary expertise through some form of specialist training. Alternatively, generalist auditors can conclude that transfer pricing is the preserve of specialists and not something they themselves need to master.

Box 17. South Africa

South Africa experienced some of these difficulties:

In the early days of transfer pricing work in South Africa, economists and tax auditors with no economics experience or knowledge sometimes struggled to understand one another but both were needed to deliver a good job. For example, economists can sometimes find it difficult to appreciate the precise nature of the arm's length principle. But economists with experience of working in the field of competition and price fixing could be very useful because they are used to making comparisons with what has happened and what might have happened in a hypothetical situation. Their skill set was better aligned to transfer pricing work than that of macro economists. External experts can add real value in some cases, but tax advisers need to be expert too, albeit in a different way.

Box 18. Canada

Canada's experience is different:

Canada is one of a number of countries that did not make routine use of economists but is now increasing the number of economists it employs.

The CRA currently has 20 economists in the International Tax Division and about 12 economists work for the Competent Authority. The 20 economists are embedded in the International Audit Team and work alongside auditors. As a result they travel around Canada a good deal. CRA has a university recruitment program for those with a Master's degree or PhD and they receive further training and have a specific career track. Auditors in the field value the services provided by economists in transfer pricing cases. CRA has found it is useful to involve economists in the initial risk assessment process and in the appeals function.

Overall it is clear that transfer pricing is a specialised subject and, while organisational models vary between tax administrations for good reasons, they all need to address the need to build up the necessary expertise and experience of managing transfer pricing issues. Knowledge management, which seems to go hand in hand with good governance, plays an important part in improving the quality and consistency of transfer pricing settlements. The organisation of the work should also help to develop a good working relationship between specialists and general auditors working on the case. Tax administrations have also found external specialists to be of value but they need to look for opportunities to secure knowledge transfer from those specialists where they can and have to manage the costs involved with some care.

Key thoughts for the chapter

Many tax administrations face a constant challenge in maintaining sufficient expertise in their organisation to tackle the toughest transfer pricing cases. Improving knowledge management and training are essential to meeting this challenge. For some tax administrations that is best done through the use of large, mixed teams whose members develop complementary skills and experience. Others maintain a core team of specialists who support colleagues in front line units. External specialists also have an important part to play in supporting the transfer pricing work of tax administrations.

Chapter 8

Transfer pricing and developing countries

This chapter is concerned with the challenges developing countries face in the field of transfer pricing. It considers some of the ways in which those challenges can be overcome and the part international co-operation has to play. It also looks at ways in which access to information and comparables could be improved in developing countries.

Introduction

Context

There is a growing awareness on the part of developing countries of the risks posed by transfer pricing. Their goal in addressing these risks is identical to that of developed countries – to protect their tax bases while continuing to attract foreign direct investment and facilitate cross border trade. It is important to note that for some developing countries the tax base is still relatively small and for a subset it is still less than the aid they receive. Consequently it is not surprising that many developing countries are inexperienced in dealing with transfer pricing issues and their top priority is to assess the level of potential transfer pricing risk in their own country and grow capability and increase capacity in their tax administrations to effectively address that risk.

A recent report to the G20 on "Supporting the Development of More Effective Tax Systems"[1] considers some of the challenges developing countries face in the field of transfer pricing and some of the ways in which those challenges can be addressed. In their final declaration following the G20 Summit in Cannes the G20 leaders had this to say: "Consistent with the Multi-Year Action Plan agreed in Seoul, we strongly support developing countries mobilisation of domestic resources and their effective management as the main driver for development. This includes technical assistance and capacity building for designing and efficient managing of tax administrations and revenue systems and greater transparency, particularly in mineral and natural resource investment. We urge multinational enterprises to improve transparency and full compliance with applicable tax laws. We welcome initiatives to assist developing countries, on a demand led basis, in the drafting and implementation of their transfer pricing legislation. We encourage all countries to join the Global Forum on Transparency and Exchange of Information for Tax Purposes." This Chapter looks at the practical steps that can be taken to overcome the administrative challenges developing countries face in the field of transfer pricing and to improve financial transparency. It also considers the specific ways in which the FTA can provide the demand led assistance that the G20 declaration envisages.

There is a limit to what any country, whether developed or developing, can achieve acting alone and so international co-operation has a crucial part to play. Developing countries have much to learn from one another about the practical solutions to the problems they face, both in terms of building capacity and in relation to specific cases, and regional organisations such as ATAF and CIAT provide a means of facilitating this dialogue and the pooling of knowledge and best practice. In addition, international bodies such as the OECD, International Monetary Fund and the World Bank have a part to play too as do countries that have tackled these types of challenges in the past and are able to share skills, knowledge and experience. Some developing countries may also buy in learning from major private sector tax firms but this can give rise to potential conflicts of interest where the firm is active in providing tax advice to private sector entities in the developing country and/or in its trading partners.

When considering the scope of their transfer pricing programmes, developing countries may wish to focus initially on the business sectors in their economy and types of transactions where transfer pricing issues are most likely to be found – for example, the exploitation of mineral wealth and other types of natural resource, manufacturing, service industries and wholesale/retail supplies. This may be a more efficient use of resources than seeking to develop a transfer pricing regime focused, for instance, on an emerging financial services industry.

Challenges

For many developing countries the first challenge is to understand the number and type of MNEs operating in their jurisdiction and the types of transfer pricing risks that are likely to arise. This assessment

will help them to devise and implement transfer pricing rules suited to their strategic needs and their particular environment. The first difficulty is how to devise rules without having a full knowledge of the issues to be addressed and the problems that can arise. Learning from the experience of others is important in this context as even the most sophisticated transfer pricing regimes started in a modest way and were built up over time (many OECD countries had limited transfer pricing expertise in the 1970's and '80's). And best practice in transfer pricing is dynamic as it adapts to changes in the commercial environment that have been discussed in this report. While there is no one size fits all solution, nonetheless there are available guide legislation and regulations (the OECD has developed model legislation that can form the basis of new laws in developing countries) which developing countries can use as a starting point to develop their own rules and practices.

Developing countries need to create a compliance regime that is proportionate to perceived risks, realistic in terms of its impact, and takes account of available capacity and capability. Developing countries will want to ensure that their tax administrations collect the right amount of tax; counter abusive transfer pricing tax planning, and create a predictable business climate, without double taxation wherever possible. An important first step is to put in place the necessary legislative framework-transfer pricing and thin capitalisation rules in particular. It is also important to take a practical approach; while expertise in these areas takes some time to build up it is important to make a start, tackling actual cases and developing the practical skills that are as important as an understanding of the principles of international taxation. And often tackling what is seen as "complex transfer pricing" may be relatively straight forward, for example, if a company is paying for goods and services (such as Head Office costs) when it has not received any real value, the cost may be disallowable on first principles.

An early aspiration for developing countries should be to ensure that they have put in place with their main trading partners double taxation agreements with effective exchange of information provisions and domestic laws that enable them to secure necessary information and documentation. Developing countries will also want to make use of the internationally agreed principles of the OECD Transfer Pricing Guidelines to help in the struggle to stop the transfer of profits abroad while curtailing the double taxation of profits for international groups.

Meeting the challenges

Training and development of people

Almost all the challenges referred to in the earlier chapters of this study apply to developing countries. Major accounting and law firms may also have limited resource in some developing countries but can call on their global resources if necessary to ensure they have all the expertise needed to handle transfer pricing cases whereas tax administrations can find themselves stretched by the complexity of cases, the lack of industry knowledge on the part of their people and a shortfall in relevant skills. These issues are often much more significant in developing countries.

The African Tax Administration Forum (ATAF), set up by 34 African Tax Commissioners to provide an African voice in taxation and promote learning and skills in African tax administrations, recognises lack of capacity and capability as a critical issue for developing countries. But there are examples of transfer pricing teams with the right mix of skills and tax administrations that have structured themselves to maximise the effectiveness of their transfer pricing resources. ATAF's members want to draw on the extensive and varied experience of developing and developed countries alike in building transfer pricing teams and how to position those teams within the tax administration.

ATAF also recognises that there is a lack of transfer pricing skills and experience in many of their member countries and sees a critical need to build those skills as quickly as possible. They envisage this

being done through technical assistance on the ground in developing countries and they see as an important mechanism this being delivered directly by tax administrations that have the relevant expertise providing technical specialists through secondments on a short term or mid-term basis and by the twinning of FTA Commissioners to provide strategic oversight. Such an approach must, however, be responsive to needs of the countries themselves and providers of assistance have a responsibility to co-ordinate this form of assistance to ensure that it is demand led, and delivered at the right time in the right way.

Box 19. Transfer Pricing Secondment from the UK to South Africa

- HMRC recently seconded a senior transfer pricing specialist to SARS for a 5 year period. He has helped SARS develop a leading edge transfer pricing function made up of tax specialists and economists. SARS also made him available to ATAF to provide technical advice to ATAF on developing transfer pricing capacity in member countries. Working with ATAF he has assisted in identifying a range of transfer pricing products to build transfer pricing capability and capacity in ATAF member countries. These include:
  - Guidance on drafting transfer pricing legislation
  - A panel of transfer pricing specialists from other tax administrations to answer anonymised technical transfer pricing enquiries from ATAF member countries
  - Web-based transfer pricing knowledge and commercial data sets
  - Risk analysis guidance
  - A joint business, tax adviser, tax administration forum to discuss transfer pricing issues
- An action plan has been drawn up to meet these needs in some cases within the next year and in others within the next 2 to 3 years.

Another approach is for a developed country to bring inside its transfer pricing team colleagues from another country who want to learn new skills and techniques (but not to work cases). Officials from China's SAT have worked in HMRC in this way for several years.

ATAF have made it clear that they intend to develop a register of resources (as well as needs) on transfer pricing and in this context the FTA should establish and maintain a register of countries prepared to provide assistance to tax administrations in developing countries that are looking to build up their transfer pricing skills. The register would identify the particular areas of expertise in which a country can provide assistance. This would involve individual countries with expertise in a particular aspect of transfer pricing agreeing to offer in depth support to a partner country in the developing world.

Framing transfer pricing rules and practices

As has been acknowledged, transfer pricing legislation is a necessary first step in dealing with transfer pricing risks but many developing countries either have no specific transfer pricing legislation or need to strengthen it. Although they may seek assistance from private sector organisations in framing their transfer pricing legislation, few such organisations have all the necessary and relevant experience. The OECD model legislation is a useful starting point but this is another area where countries experienced in developing and applying legislation may be able to provide that assistance, and potential support could be included in the register proposed above. In a similar way, there have been calls for the FTA and ATAF to work together to develop a hand book of anonymised transfer pricing case studies that could be drawn on by developing countries to assist in framing the rules and practices and growing their capacity.

Transfer pricing risk assessment in the developing world

Transfer pricing resource is both scarce and expensive for tax administrations in developing and developed countries but this may be a more significant issue in developing countries. Developing countries have told us that it is critical that they are able to identify effectively the highest risk cases to ensure the most effective use of their limited resources. Risk-based case selection is also vital for creating a strong investment climate providing certainty for business.

Chapter 2 suggests how tax administrations can best identify transfer pricing risks, what sources of information can be useful, and how best that information can be obtained and used to influence case selection. The examples and techniques referred to there are all relevant for developing countries but more fundamental issues in obtaining basic information can arise.

A description by one African Tax Commissioner of their experience is set out in the box below. Other developing countries say they face similar difficulties.

Box 20. Difficulties in obtaining relevant information – an African Tax Commissioner's Experience

- Multinational enterprises can be economical with the provision of data and information to auditors and inspectors. This can make it extremely difficult for tax administrations to prove that their transfer pricing concerns are well founded. In many cases key information is thought to be deliberately withheld from the tax administration in order to hide the potential tax liabilities.
- In other circumstances, multinational enterprises overwhelm tax administrations with volumes of irrelevant information with the result that the attention is diverted from the real information that the tax administration needs to reach proper conclusions.
- Double Tax Agreements are not always effective in securing vital information needed in a transfer pricing audit or enquiry. Often the tax administration requesting the information has to wait for long periods of time, sometimes over six months before receiving any feedback and even then it might not receive the crucial information it needs.
- Management fees are one of the many ways that multinational enterprises are using to reduce taxable profits in African countries. Usually these fees have no relationship with the actual cost of providing any management services but are just expressed as a fixed percentage of revenues. When questioned about the justification of the fees, the multinational enterprises provide a figure of Head Office expenses that has been apportioned to the entity which eventually bills the African entity. When requested to provide the trial balances of the Head Office so that the tax administration can apply its mind to the expenses apportioned, a multinational's subsidiary or branch says that it does not have access to that information. The conclusion the taxpayers make is that even if a direct method of charging the African entity was used, the results would have been the same or an even higher charge could have been made to the African entity.
- Another example of difficulty relates to management fees. Often management fees are charged where the local company has competent and capable management of its own. There is often visible duplication of functions and/or services but multinational enterprises seek to find ways of explaining away any duplication. Auditors and inspectors are sometimes not sure what criteria to apply to decide whether to accept these explanations as valid. For example, the taxpayer will usually describe a lot of value adding activities that the parent company or related party is performing, and yet these aspects will be outside the scope of the contract signed between the related parties, and the contract is the only legal basis of the management fees that are being paid.
- The use of tax havens is still prevalent in an African context. Goods are often sold by a related party to the tax haven entity which simply acts as a re-invoicing vehicle. An inability to access financial statement of the tax haven vehicle can make it hard to test whether re-invoiced prices are arm's length prices. This problem is further compounded by the lack of transfer pricing documentation in Africa. The majority of subsidiaries of branches of multinational enterprises simply state that they do not have transfer pricing documentation but they are transacting with related parties at arm's length. Even in situations where the transaction is not routed through a tax haven vehicle, the lack of information from the other group entity regarding their margins and other accounting ratios makes arm's length testing in the value chain very difficult.
- The tax authorities' lack of access to databases like Amadeus and Orbis, and the lack of knowledge on how to carry out an economic analysis based on such databases where they are available is a problem that makes transfer pricing audits and enquiries even harder.

This testimony illustrates how problematic transfer pricing can be and the particular difficulties associated with the issue of management fees. However, it is possible to challenge the arbitrary allocation of head office expenses on the basis that there is no evidence of any value being received, or if there is value added that it is not proportionate to the amounts being charged. This is an example of how the application of first principles, rather than complex transfer pricing concepts, can be very effective. It is helpful if the legislative framework makes it clear that it is for the MNE concerned to establish that the level of management fees is justified by the value that has been added by the other parts of the MNE. But this does not alter the fact that a lack of good quality commercial information in developing countries is a major challenge for their tax administrations.

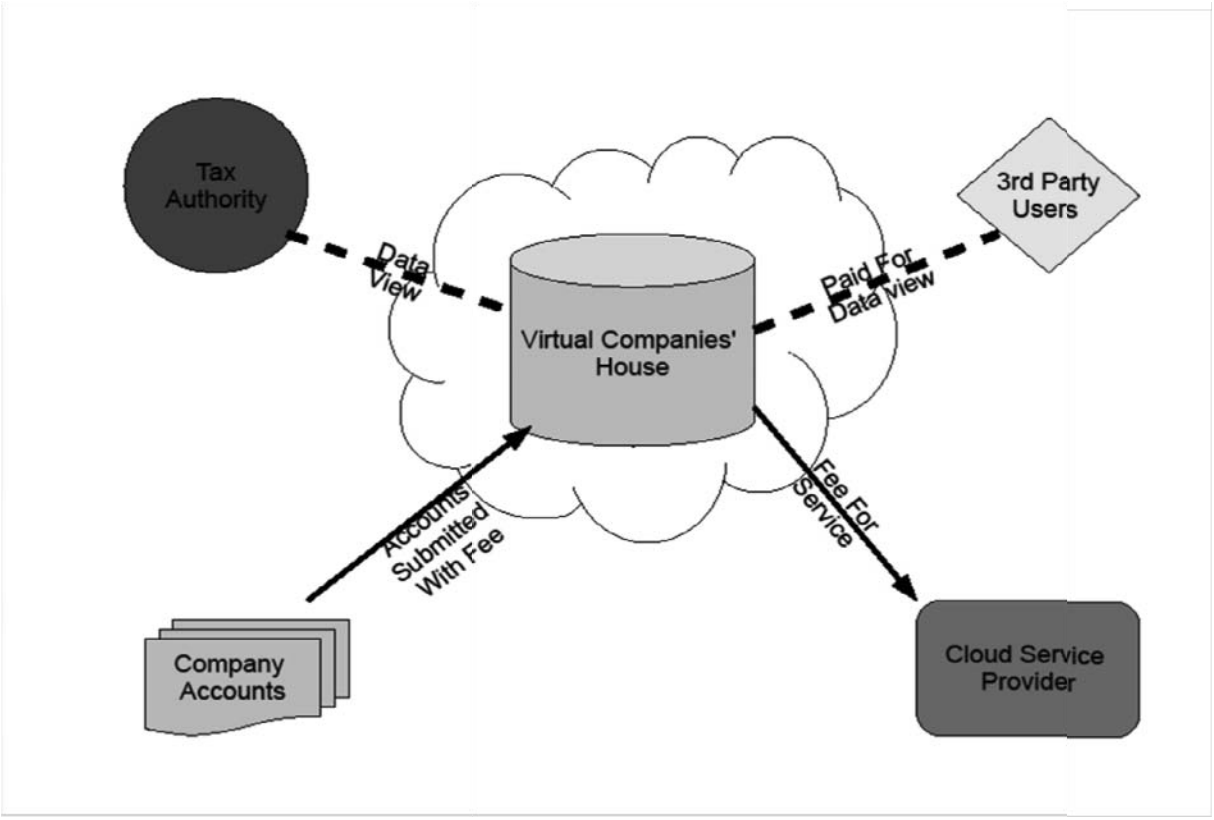
Improving access to commercial information and comparables in developing countries

The identification of comparables can create particular difficulties for developing countries wanting to undertake effective transfer pricing audits or enquiries. Some have access to business and commercial databases for use in transfer pricing enquiries but there is often a lack of financial data in their own countries that would be of use in determining arm's length prices for independent companies. This can force tax administrations to use non-domestic comparables and in some cases to make company specific adjustments for the difference between the domestic market and the foreign market. This can add real complexity and cost as well as proving very time-consuming. ATAF is looking at the feasibility of purchasing rights to use a commercial database for collective use by its members and at the possibility of ATAF members developing their own databases.

The availability of financial data in a country is greatly improved if there is a reporting system that encourages financial transparency in the corporate sector. This can be achieved by having in place a legislative framework that imposes a requirement on companies, including private companies, to file accounts and for those accounts to be publically available. This sort of requirement can be found in the company law systems of many countries. There are very good non-tax reasons for doing this, as it helps to improve the transparency of markets and so helps them to be more efficient. It helps to create the climate in which third party investors can make informed decisions about which corporations to lend to, or directly invest in. In the absence of this kind of transparency, investors and enterprises are much more likely to have to rely on personal and family connections when making financial decisions.

The requirement to file accounts does impose a compliance burden on the companies affected but enterprises of any scale will need to have accounting systems in place in order to run their businesses. It is already a legal requirement in many OECD countries. Smaller companies can be subject to less stringent requirements than large companies and the local subsidiaries of MNEs, which prevents the system placing undue burdens on the SME sector. The legislative framework should also specify the accounting standards that companies should comply with, which could be local GAAP or the International Accounting Standards. A project is currently underway, led by the OECD's multistakeholder Informal Task Force on Tax and Development, to establish good practices for transparency in the availability of company accounts, and to assist countries in putting in place rules to enable the public availability of relevant data. This is an area where the FTA could work closely with the Task Force to develop an integrated solution.

The development of a legal framework for financial reporting in the corporate sector is an important first step but it needs to be backed up by an administrative mechanism for receiving the accounts of corporations and making them available for public scrutiny. In the current era that system needs to be electronic, as this is the simplest way to receive the information and the Internet is the easiest way to make the data publically available. But for many developing countries it will be hard to fund any significant capital investment in this sort of IT system and it may not represent the highest priority when funds are scarce. Fortunately, developments in the market place, particularly in the provision of computing capacity as a service, often referred to as cloud computing[2], suggest that it should be possible to establish an electronic system for receiving and accessing company accounts relatively easily and at low cost. The diagram below illustrates how this might be done.



Source: OECD (2011) "Dealing Effectively with the Challenges of Transfer Pricing", internal working document, Centre for Tax Policy and Administration, OECD, Paris.

Once the legal framework is in place, cloud computing could be the means to put in place an electronic system for receiving and publishing accounts at low or no cost to the tax administrations and governments involved. The key steps in the process illustrated in the diagram are as follows:

- A cloud service provider establishes a publicly accessible database of accounts. If several countries chose to agree a common reporting format, this could be a multilateral system. The reporting and database requirements can be structured in a way that supports increased financial transparency and the analysis of business results that will be of value to tax administrations. As the database of accounts grows, issues of scale are managed by the service provider and there is no upfront capital cost, or maintenance and replacement costs, to meet as the service provider manage those and simply charges for usage.

- Companies are subject to a legal requirement to file electronically and it will be clear when they have not done so because the database is public. The filing format can be specified and a number of countries have already developed electronic formats for the e-filing of accounts along with tax returns.

- Income can be generated by charging fees when the accounts are filed, or if that is seen as a disincentive, from penalties for late filing.

- Third party users could also be charged to access the data as this will be of commercial value to various people, for example potential customers of a company and financial institutions considering loan requests from, or investment in, the corporate sector. Income from third party

users, combined with filing fees and penalties for late filing could cover some, or possibly all, of the running costs.

- To access the data the tax authority simply needs to visit the relevant website and so needs no special technology beyond a connection to the Internet.

Over time this approach would give tax administrations access to a wide range of reported results in the corporate sector in their own country and in others. Costs should be low and offset by improvements in compliance that would result. The feasibility of this solution could be explored further as part of any joint work between the FTA and the Task Force on Tax and Development.

Chapter 1 of this study recognised that a large proportion of international business transactions take place within multi-national groups and can involve very complex structures. Often developing countries see only one small part of the multi-national enterprise – as the experience of the African administration described above illustrates – and it is very rare for the commercial centre of the whole multi-national business to be based in their country. These difficulties can sometimes be overcome by the developing country's tax administration having a good working relationship with a subsidiary or branch of a multi-national enterprise, and sometimes with the principal company, in line with the principles in the FTA's *Study into the Role of Tax Intermediaries*[3]. This should be supplemented by the active use of exchange of information provisions in bilateral and multilateral agreements. The Multilateral Convention on Mutual Administrative Assistance in Tax Matters is the most comprehensive multilateral instrument available in the tax field. It is broad in scope and as well as assisting countries in the field of transfer pricing, can be used for fighting tax evasion and other law enforcement purposes, such as fighting corruption and money laundering.

Where that is not the case, a developing country will need an effective regime for obtaining information available within the country, viable sanctions for failure to maintain or obtain key documentation, and an ability to tax a realistic estimate of the full profit where there is no co-operation. Some multi-national enterprises have already shown a genuine willingness to help developing countries devise effective transfer pricing regimes and that is to be welcomed. A project under the Task Force on tax and development, delivered by the OECD, World Bank and EU with the support of ATAF, has put in place a bilateral assistance programme with particular countries which engages both business and civil society along with government to ensure that the transfer pricing rules are effective, enforceable and not overly burdensome. Another initiative to take place within the next twelve months involves a global multi-national enterprise, a major firm of tax advisors and a developed country tax administration coming together to work with an African tax administration to address the issues in Box 20 above.

Settling transfer pricing disputes

Transfer pricing audits and enquiries can often involve significant amounts of tax and generally there is no single right answer. As a result most transfer pricing disputes need to be settled through negotiation with the tax administration and the MNE making compromises. As we have seen, this uncertainty makes it critical to have strong governance processes in place within the tax administration to address both issues of propriety and consistency in decision making.

In most transfer pricing cases acceptable outcomes are usually achieved through negotiation. But tax administrations in developing countries can lack experience of concluding cases in this way. Concerns about corruption mean that they have reservations about trusting too much in auditor or inspector discretion. More experienced tax administrations can help in this context by sharing their skills and their approaches to governance (see Chapter 4 above) and the FTA is committed to working with ATAF to

achieve this. This will represent a valuable addition to the work of the Global Forum on Transparency and Exchange of Information for Tax Purposes and the Informal Task Force on Tax and Development.

In general, developed countries have larger networks of information exchange and double taxation agreements than developing countries. They are therefore likely to have more experience of negotiating exchange of information articles in their treaties and tax information exchange agreements. These are skills which could be shared to good effect with developing countries and should be included in the register referred to above.

Key thoughts for the chapter

Over the last five years developing countries have grown their awareness of the risk of significant tax loss through transfer pricing and the importance of developing their skills and expertise to meet this challenge. Although many multi-national enterprises invest significantly to ensure that transactions which do not take place in an open market are priced properly, a number do not and there are growing concerns that the economies of developing countries are disadvantaged by their failure to do so.

Many of the issues faced today by developing countries share common features and have previously been addressed by others. It follows that the best source of support for developing countries in the context of transfer pricing lies in closer international collaboration amongst developing countries in comparable situations and more widely in the international community. This will help tax administrations in developing countries to improve their transfer pricing skills and knowledge while at the same time levelling the trading playing field across the globe.

There are two key recommendations to assist this process. First, delivering the register referred to above. With co-operation from all members of the FTA it should not be too difficult to develop. The FTA could also help to develop a diagnostic tool that will help developing countries to identify the aspects of their transfer pricing regime that are priorities for improvement. That will allow them to make more informed choices between the types of assistance catalogued on the register.

Second, ATAF is already planning a conference on transfer pricing to share knowledge and build expertise. This should take place in an ATAF member country during 2012. The FTA should work with ATAF to agree how it can contribute to that event and help partner experienced and less experienced tax administrations to find solutions to key challenges on transfer pricing that are the right solutions in the context of the individual needs of African countries. The OECD Task Force is already closely involved with this event. The FTA and the Task Force will co-ordinate their contributions.

The FTA should lend its support to the joint European Commission, OECD and World Bank pilot study in Ghana and, if this is a success, it could be extended to other countries. More generally, the FTA should encourage all countries to adopt a more pragmatic approach to transfer pricing, recognising that it is more of an art than a science. In this context the work of the United Nations on a practical manual on the application of the arm's length principle is very welcome, as is the work that the OECD's Working Party 6 is now commencing on the simplification of transfer pricing.

Notes

1 The full title of the report is "A Report from the International Organisations mandated by the G20 to support the development of more effective tax systems" and was prepared by the IMF, the OECD, the United Nations and the World Bank.

2 The term “cloud” has been around for a while but the cloud symbol is now commonly used to represent the Internet. “Cloud computing” is a generic term for the delivery of information technology services over the Internet. Probably the most basic form of cloud computing service is the provision of data storage but cloud computing services now extend well beyond the provision of data storage facilities over the Internet. A fuller explanation of cloud computing is set out in Annex 6.

3 Ibid.

Annex A: Denmark

SKAT

Controlled transactions

1(3)

Appendix to income tax return

Income year

Name

Business reg.no. (CVR) or Civil reg. no. (CPR)

Appendix to the income tax return concerning controlled transactions. cf. Section 3 B of the Tax Control Act.

All points 1.-6. must be completed	Yes (tick)	No (tick)
1. Exerts decisive influence on legal persons or has a permanent establishment abroad		
2. Is subject to decisive influence from individuals or legal persons or is an individual or legal person with a permanent establishment in Denmark		
3. Is otherwise associated with a legal person		
4. Is covered by paragraph 6 in section 3 B of the Tax Control Act		

5. The taxable unit's principal field of activity:

Tick appropriate boxes ☐ Production ☐ Trade ☐ Financial ☐ Service ☐ Other

6. Exact number of units with which there have been controlled transactions

in Denmark: ☐ of which are jointly taxed: ☐

in the EU/EEA: ☐ of which are jointly taxed: ☐

in states outside the EU/EEA with which Denmark has signed a double tax convention: ☐ of which are jointly taxed: ☐

in states outside the EU/EEA with which Denmark has *not* signed a double tax convention: ☐ of which are jointly taxed: ☐

Guidance

Point 2 The expression 'legal persons' also includes the so-called transparent entities, i.e. companies and associations etc. that, according to the Danish tax rules, are not in themselves individual tax units, but units regulated by the corporate laws, a company agreement, regulations of the association or the like, e.g. a limited partnership (K/S) or a partnership (I/S). For income years beginning on the 1st of January 2007 or later, foreign individuals and legal persons that are taxable in Denmark from a hydrocarbon allied company according to paragraph 21, section 1 or 4 of the Hydrocarbon Act, are also subject to the information and documentation requirements of paragraph 3B of the Tax Control Act, even if they do not have a permanent establishment according to the standard definition.

Point 3 Tick "yes" if the taxable unit is subject to decisive influence from the same shareholders or the same management as another egal person. A legal person can also be a tax-transparent unit, cf. the above paragraph.

Point 4 Tick "yes" if the taxable unit belongs to a group of companies with less than 250 employees and either a balance sheet below DKK 125 million or a turnover below DKK 250 million. These taxable units must only produce transfer pricing documentation for controlled transactions with units resident in states with which Denmark has not signed a transfer pricing-relevant double tax convention (DTC), and which are not members of the EU/EEA, cf. paragraph 3B, section 6 of the Tax Control Act. The states with which Denmark has transfer pricing-relevant DTCs, can be seen in the tax assessment guidelines on double taxation. The agreements with Hong Kong, Iran, Jordan, Lebanon and the CIS countries do not cover the question of associated companies and are therefore not considered to be transfer pricing-relevant DTCs.

Point 5 The taxable unit's principal field of activity should be stated generally, that is, not limited to controlled -transactions.

Point 6 A unit is an associated party as defined in point 1-3. Legal persons in point 2 and 3 can also be tax-transparent units. Write "0" if there has not been any controlled transactions with the units resident in one or more of the geographical areas indicated. The states with which Denmark has a transfer pricing relevant DTC, can be seen in the tax assessment guidelines on double taxation, cf. point 4 of this guidance.

Example: If there have been transactions with associated entities in Denmark and Iran write "D" in the box.

Guidance *(continued)*

Page 3

The types of transactions are stated on page 3 of the form. Information should be given about the taxable unit's total controlled transactions. Types of transactions not comprised by the specific types in the table should be listed under "other".

For each individual type tick off in the relevant column whether the transactions are less than DKK 10 mill., between DKK 10 and 100 mill. or above DKK 100 mill. All figures should be calculated gross as the sum of transactions of the type in question with all the units with which there have been controlled transactions.

If controlled transactions of the type in question exceed 25 % of the taxable unit's total transactions of the type in question, tick off in the column "above 25 %".

For each individual type write in which state(s) the unit(s) with which there have been controlled transactions is/are resident. Put either A, B, C or D on the line, where

A = only in Denmark

B = only in states within the EU/EEA. This might include Denmark

C = also in states outside the EU/EEA with which Denmark has signed a double tax convention. This might include both Denmark and states within the EU/EEA.

D = also in states outside the EU/EEA with which Denmark has *not* signed a double tax convention. This might include both Denmark and states within and outside the EU/EEA with which Denmark has signed a double tax convention.

Example: If there have been transactions with associated entities in Denmark and Iran write "D" in the box.

Do not tick if there haven't been any controlled transactions of the type in question during the income year.

Points 8-9 Gifts are regarded as equivalent to purchases and sales.

Points 10-11 Incomes and expenses relating to services cover any allocation and distribution of costs among the units in question regardless of their designation.

Points 14-15 Incomes and expenses relating to intangible assets comprise royalties and similar payments for the use of intellectual property.

Points 16-17 Financing incomes and expenses also comprise profits and losses in connection with financial contracts.

Point 22 Sales of intangible assets comprises assets acquired against remuneration as well as sales of intangible assets developed within the company whether the research and development costs have been capitalised or carried as expenses.

Points 30-31 The total maximum loans calculated as the sum of the maximum loan to or from each unit assessed on the day of the income year when it was largest.

Points 32-33 Options, futures, swaps and forward rate agreements etc. are considered as financial contracts.

Income year	Business reg.no. (CVR)	or	Civil reg. no. (CPR)

Type of controlled foreign transactions	Gross figure in DKK mill. below 10	between 10-100	over 100	over 25 %.	State: (A - D)
Profit and loss account:					
8. Sale of goods and other current assets					
9. Purchase of goods and other current assets					
10. Incomes from services, including management fees, and cost sharing					
11. Expenses for services, including management fees, and cost sharing					
12. Rental and leasing incomes					
13. Rental and leasing expenses					
14. Incomes deriving from intangible assets					
15. Expenses relating to intangible assets					
16. Financing incomes					
17. Financing expenses					
18. Subsidies received, including waivers of loans					
19. Subidies given, including waivers of loans					
20. Other incomes					
21. Other expenses					
Balance sheet:					
22. Sale of intangible fixed assets					
23. Purchase of intangible fixed assets					
24. Sale of tangible fixed assets					
25. Purchase of tangible fixed assets					
26. Sale of capital participation in associated companies					
27. Purchase of capital participation in associated companies					
28. Sale of other financial fixed assets					
29. Purchases of other financial fixed assets					
30. Loans from legal persons or individuals (max. in the income year)					
31. Loans to legal persons or individuals (max. in the income year)					
32. Other financing granted, including financial contracts					
33. Other financing received, including financial contracts					

Please note that the submission by e-mail is **not** secure unless you either **encrypt** or attach a **digital signature** to your message and the attached data file.

Annex B: South Africa

TRANSFER PRICING QUESTIONNAIRE: SOUTH AFRICAN-OWNED MULTINATIONAL GROUPS

1. Please complete the following questions based on the latest completed IT14 tax return for the latest year submitted.

2. In responding to the questions you may provide separate written comments if you wish to give clarification on any issue or identify assumptions made.

3. All values should be stated in South African Rands.

a. Name of Company	
b. Company registration number	
c. Company tax reference number	
d. Company VAT reference number	
e. Registered address of company	
f. Name, telephone number and email address of the public officer	
g. Name and contact details of the tax advisors	
h. Total value of international related party transactions undertaken	

4. Please provide a description of the principle activities of the South African company.

5. The following information is required to understand the nature and quantum of the transactions with non-resident related parties.

	Received from non-resident related parties	Supplied to non-resident related parties
Goods		
Raw materials		
Processed or finished goods		
Other (specify)		
Rents, royalties, license fees or franchise fees		
Intangible property transferred		

Services		
Management and administration		
Technical		
Research and development		
Commissions		
Financial		
Interest		
Insurance		
Other (specify)		
Other		
Reimbursement of expenses		
Cost sharing / cost contribution arrangements		
Employment costs for expatriate employees		
Other (specify)		
Total Value of transactions with non-resident related parties		

6. The South African Revenue Service recognises the transfer pricing methods endorsed by the Organisation for Economic Development and Co-operation (OECD) in its Guidelines on Transfer Pricing for Multinational Enterprises and Tax Administrations (1995), the OECD Guidelines. These methods are outlined in Practice Note 7 issued on 6 August 1999. Please specify the transaction value for each of the transactions identified above, against each of the methods used to set or test the appropriateness of the pricing policy adopted. If more than one method was used please provide further details of such methods used and allocate the value against the primary method used. Please note that the total value of transactions should equal the total from the above table.

Method	Received from non-resident related parties	Supplied to non-resident related parties.
Comparable Uncontrolled price (CUP)		
Resale Price Method (RP)		
Cost Plus Method (CP)		
Transactional Net Margin Method (TNMM) Transactional Profit Split Method (TPSM)		
Other method (specify)		
Not tested		
Total Value of transactions		

7. Has the company provided any goods or services (including the provision of financial assistance) to a non-resident related party for no consideration?

If so, please provide details	

8. Have any of the transactions listed in above occurred with a non-resident related party which is tax resident in a tax haven or low tax country?

If so, please provide details	

9. Has the company prepared transfer pricing supporting documentation for the transactions listed above?

If so, indicate (based on transaction value) the approximate percentage of the transactions supported by such transfer pricing documentation.	

10. Please provide copies of the annual financial statements for the latest tax year for which an IT14 has been lodged for each of the international related parties with whom transactions have been concluded.

11. Please provide details of the representative from the company completing the questionnaire for future reference, should we require further information.

Name	
Position/Title	
Contact number	
E-mail address	

TRANSFER PRICING QUESTIONNAIRE: FOREIGN-OWNED MULTINATIONAL GROUPS

1. Please complete the following questions based on the latest completed IT14 tax return for the latest year submitted.

2. In responding to the questions you may provide separate written comments if you wish to give clarification on any issue or identify assumptions made.

3. All values should be stated in South African Rands.

a. Name of Company	
b. Company registration number	
c. Company tax reference number	
d. Company VAT reference number	
e. Registered address of company	
f. Name, telephone number and email address of the public officer	
g. Name and contact details of the tax advisors	
h. Name and country of incorporation of holding company and ultimate holding company (if different)	
i. Tax residence of holding company and ultimate holding company (if different)	

4. Please provide a description of the principle activities of the South African company.

5. Please provide details of the principal activities of the ultimate parent company and its consolidated group.

6. The following information is required for the purpose of calculating various accounting ratios for comparison purposes. The intention is to compare the performance of the South African company with that of the consolidated group of the ultimate parent company. If your company is performing below consolidated group levels you may wish to provide an explanatory note.

	South African Company	Holding Company (Consolidated)
Total Assets		
Operating Assets		
Current Liabilities		
Turnover		
Gross profit		
Total expenses		
Operating expenses		
Operating profit		

7. The following information is required to understand the nature and quantum of the transactions with non-resident related parties.

	Received from non-resident related parties	Supplied to non-resident related parties
Goods		
Raw materials		
Processed or finished goods		
Other (specify)		
Rents, royalties, license fees or franchise fees		
Intangible property transferred		
Services		
Management and administration		
Technical		
Research and development		
Commissions		

Financial		
Interest		
Insurance		
Other (specify)		
Other		
Reimbursement of expenses		
Cost sharing / cost contribution arrangements		
Employment costs for expatriate employees		
Other (specify)		
Total Value of transactions with non-resident related parties		

8. The South African Revenue Service recognises the transfer pricing methods endorsed by the Organisation for Economic Development and Co-operation (OECD) in its Guidelines on Transfer Pricing for Multinational Enterprises and Tax Administrations (1995), the OECD Guidelines. These methods are outlined in Practice Note 7 issued on 6 August 1999. Please specify the transaction value for each of the transactions identified above, against each of the methods used to set or test the appropriateness of the pricing policy adopted. If more than one method was used please provide further details of such methods used and allocate the value against the primary method used. Please note that the total value of transactions should equal the total from the above table.

Method	Received from non-resident related parties	Supplied to non-resident related parties.
Comparable Uncontrolled price (CUP)		
Resale Price Method (RP)		
Cost Plus Method (CP)		
Transactional Net Margin Method (TNMM) Transactional Profit Split Method (TPSM)		
Other method (specify)		
Not tested		
Total Value of transactions		

9. Has the company provided any goods or services (including the provision of financial assistance) to a non-resident related party for no consideration?

If so, please provide details	

10. Have any of the transactions listed in above occurred with a non-resident related party which is tax resident in a tax haven or low tax country?

If so, please provide details	

11. Has the company prepared transfer pricing supporting documentation for the transactions listed above?

If so, indicate (based on transaction value) the approximate percentage of the transactions supported by such transfer pricing documentation.	

12. Please provide details of the representative from the company completing the questionnaire for future reference, should we require further information.

Name	
Position/Title	
Contact number	
E-mail address	

Annex C: France

Getting off to a good start: the approach in France

Introduction

International issues and transfer pricing in particular are a major audit target for the French tax administration (la Direction general des Finances publiques).

la Direction general des Finances publiques recognises that, due to the complexity of transfer pricing issues, transfer pricing audits require highly technical skills and special measures (training, documentation, private databases access).

For reasons of efficiency and legal certainty, in 2008, the Central Office decided that transfer pricing audits would be performed by national and inter-regional tax audit directorates. The large companies tax audit directorate (Direction des Vérifications Nationales et Internationales - DVNI) deals with the majority of transfer pricing cases as it is in charge of the audit of main groups and big companies.

To optimise resources, two options have been proposed to these audit directorates:

- creating dedicated services that will be in charge of the most significant transfer pricing cases; or

- creating a team of transfer pricing experts that can help general tax auditors on the transfer pricing aspects of their case.

The DVNI chose the second option and has a team of about ten experts. As a consequence, transfer pricing audits can take various forms:

- a general tax auditor may conduct his audit alone or with other general tax auditors; or

- a general tax auditor may conduct his audit with the assistance of a transfer pricing expert working for him; or

- several tax audit services (and also several tax auditors in charge of their own audit) work in co-ordination.

For example, tax audit services in the same directorate or sometimes in different ones can come together to define a common strategy of transfer pricing control by the action of auditing several companies working in the same economic area or in the same group, in the same timeframe. That sort of operation can gather a lot of information that then needs to be considered carefully, which can take some time, before a particular audit can begin. When it is the case that a general tax auditor also needs the help of a transfer pricing expert, agreed timeframes with that expert are necessary to ensure the expert's availability.

In all cases, identifying the scope of potential transfer pricing issues and getting enquiries off to a good start are the main objectives of the initial fact finding searches and preliminary consideration of the potential transfer pricing issues identified. Efficiency of approach is also improved by close collaboration and dialogue between the different parties.

Scoping and preparing a transfer pricing case

Planning a transfer pricing audit with risk analysis

In France, tax audit directorates establish a practical strategy of international tax audit, in line with the national strategy set by the Central Office and with the bi-annual audit plan set by each interregional audit directorate and approved by the Central Office.

Risk analysis is used to identify cross border issues. Furthermore, in order to improve the case selection of transfer pricing audits, several services take part in mutual risk identification and analysis: general tax audit service, transfer pricing expert team and the head office of the tax audit directorate.

All of those services take into account their economic knowledge derived from their experience (tax audit teams are specialised by economic activity and belongs to a pool of several audit teams specialised by economic sector), the tax returns of companies, previous tax audits, mutual agreement procedures and advance pricing agreement if any, together with news and information from public or private database.

These are a few examples of planning issues:

- companies which have subsidiaries located in low tax or zero tax countries and territories;
- companies which are not profitable during a long period and which are held by profitable foreign group;
- business restructuring;
- transfer of intangibles.

Anticipating needs of transfer pricing expert help

In order to shorten the timeframe for dealing with transfer pricing cases, it is important to determine, at this stage, a first list of companies where a transfer pricing expert will join a general tax auditor to form a transfer pricing audit team.

In practice, transfer pricing experts work for the national and international tax audit directorate; they can occasionally help general tax auditors of the inter-regional tax audit directorates (where international tax experts may answer the questions of general tax auditors).

Added value is expected from transfer pricing experts

- When there are complex and high technical issues in the matter of transfer pricing;
- when there are significant amounts of money at stake;

- when there are several French companies involved that need to be audited in the same timeframe.

Coordinating the transfer pricing audit team if any

For the national and international tax audit directorate (DVNI), a transfer pricing audit team can be composed of 3 or 4 persons: one general tax auditor, one or two transfer pricing expert(s) (it depends on the nature and complexity of the case) and, generally, one IT accounting auditor. The general tax auditor is the team leader.

The co-ordination of the whole team is an important point.

The transfer pricing team leader must synchronise the team schedule where the different auditors (general, expert and IT accounting) have many other companies to audit in the same time.

Therefore, he has to ensure that the transfer pricing expert gathers all information needed to prepare the first meeting with the taxpayer.

During the tax audit, the team leader has to check the transfer pricing issues with the transfer pricing expert and to take care of the consequences of transfer pricing adjustments on other tax adjustments and vice versa. He has to follow up the different issues in order to finalise both the process of general audit and transfer pricing audit in a same timeframe.

The main objectives of the preparing phase by the audit team are:

- more effective management of tax issues in a short time;
- shorten examination processes both for revenue authorities and for taxpayers: audit teams can achieve efficient and effective results if proper planning occurs and processes are well-defined;
- increase the efficiency and effectiveness of discussions between taxpayers and team audits on technical and complex issues.

Good preparation of the transfer pricing team audit can also contribute to:

- a productive relationship;
- improving the understanding by the general auditor of the transfer pricing audit methodology for future audits;
- inform the general auditor on issues linked to the transfer pricing ones and the potential consequences of the transfer pricing adjustment on other taxes or the potential consequences of tax adjustments on transfer pricing ones.

Gathering the best information

Before the audit, the tax audit services gather the most comprehensive information they can get in order to get a good idea of the company's environment and in particular the relations it has with associated companies and the transactions it entered into.

The tax audit services will examine the company's file which contains tax returns, including documents mentioning foreign companies (holding or subsidiaries), transactions that must be declared (like loan agreements), royalties, commissions or fees paid to foreign companies (which may be part of the same group), legal statutes (which can mention foreign shareholders or chief executive officer), previous tax audit reports, the group diagram etc.

In a second review, the tax audit services will focus on further technical information: loss companies, important financial charges where loans are contracted with a shareholder or with an associated company, variations of royalties paid after a shareholder's change with no change of turnover, financial and economical ratios and other information.

All of that information can be searched for on public or private databases, company websites, newspaper or economic journals.

Typical process with transfer pricing expert

Below is a description of a typical process used by the French national and international tax audit directorate (DVNI) when preparing a transfer pricing audit. Other ways can be followed but it is a good starting point to shorten time spent on transfer pricing cases.

- Step 1: during the preparation of the annual tax audit planning, operational tax audit services, transfer pricing consulting team and tax audit head office draw up a list of the companies where transfer pricing issues have been detected; at this stage, they collect a first set of information on those companies.

- Step 2: the planning board identifies companies to be audited where transfer pricing experts should help general auditors on transfer pricing issues. It establishes a forward-looking calendar of the audits.

- Step 3: from the moment they have their tax audit planning, general tax auditors and transfer pricing experts can gather more detailed information on the companies to be audited, by consulting internal and public or private databases: economic, financial and tax information, information on the group holding the companies, where subsidiaries are located, etc.

- Step 4: planning the first meeting with the taxpayer: the general tax auditor and the transfer pricing expert determine a common schedule and establish a list of questions on the activity of the taxpayer, its relations with the other entities of the group.

- Step 5: during the first tax audit meeting (or the first transfer pricing audit meeting if different), they identify the transfer pricing specialist of the company or transfer pricing advisor with whom the audit team will manage the transfer pricing issues.

- Step 6: after a few meetings with the taxpayer, and as soon as possible, it will be determined if the help of the transfer pricing expert is still required and if so they will remain on the audit of transfer pricing issues, but if not, their contribution will stop.

- Step 7: where no transfer pricing expert has been planned in Step 1, the general auditor and his manager may nonetheless require this help, quite soon after the first meeting with the taxpayer.

- Step 8: when the tax auditor, in the course of the audit of a company, has information on another company that can lead to the examination of this other company, it is important for the good conduct of that second audit, that the tax auditor collects the most relevant information during the first one.

- Step 9: review the follow up of transfer pricing issues with the transfer pricing audit team and the taxpayer.

- Step 10: prepare the closing of the transfer pricing audit by checking the whole information on transfer pricing.

- Step 11: closing of the tax audit with transfer pricing adjustment or not.

Annex D: Transfer pricing risk identification and assessment: the perspective of an advisor of MNE's

Risk indicators for transfer pricing

Businesses engaged in certain activities raise their risk profile. A number of these activities are indicators of the potential for incorrect transfer pricing, depending on the facts and circumstances of each case:

- Intangible assets utilised by group companies but no royalty paid.
- Cost sharing with no foreseeable benefit.
- Companies involved in transactions that might be overlooked.
- Companies making losses over a number of years.
- Sustained losses by local entities, but (overall) profits in the group.
- Margins suddenly decrease with no rationale.
- Companies with overseas subsidiaries with start-up losses.
- No formal agreement for services or finance provision with no recharge of costs.
- Secondments undertaken on "un-commercial" terms (*i.*e. no recharge and no agreements).
- UK companies with related party transactions where the related party has a low marginal tax rate and makes payments which appear to be large in reference to the relationship.
- Debt levels, intra-group loans and guarantees that are "un-commercial".
- Trading debtor balances – intercompany, long term, interest free.
- Dormant companies with intercompany creditors and net assets/investments.

There are additional risk indicators flagged by tax authorities as requiring audit. Presence of these indicators does not, of itself, imply that the transfer pricing of the business is necessarily incorrect:

- Companies paying large management fees or paying royalties or other charges for the use of intellectual property.
- Companies undertaking contract R&D on a cost plus basis – tax authorities may challenge the basis of remuneration and argue that a local country is contributing towards the creation of an intangible.

- Group members who have acquired, created or enhanced an asset that is used by other group members, perhaps by incurring expenditure on research and development leading to the creation or enhancement of intellectual property.

- Companies with innovative business structures.

- Significant group reorganisations involving business transfers overseas.

- Transactions with tax havens or shelters.

- Companies in a commercial relationship with a related party where non-tax factors provide incentive for manipulation (regulatory requirements involving customs valuations, anti-dumping duties, currency exchange or price controls, or cash flow incentives within a group affecting where profit is reported or how dividends are financed).

- Loss making companies in commercial relationship with a lower marginal rate taxpayer where the loss is as a result of payments to that entity.

In addition, risks arise where transfer pricing policies and methodologies are not up to date and do not or no longer accurately reflect the operation and management of the business.

How risk assessment is undertaken

Country basis

- The statutory tax rates of the countries in which the group operates are examined, in order to determine whether there is any identifiable incentive for moving profits around the group. Transactions with tax havens are by nature higher risk and are selected for detailed examination.

- The effective tax rate (ETR) in each country is calculated and compared with the standard rates present in each country. If the ETR is significantly different from the standard tax rate, this is examined in further detail and variances explained.

- Countries in which the tax authority is known to be aggressive in respect of transfer pricing or where OECD methodologies are not followed are highlighted for more detailed review.

Business basis

- The business model commonly employed by the group is examined. This includes analysis of the key function providers, asset holders and risk takers of the group.

- In addition, the share price strategy of the group is monitored. For example, is there an incentive to move profits to the shareholder (dividend paying) entity (*e.g.* Australian imputation credit rules)?

- Local profit margin is analysed in reference to that company's activities within the group.

- Local profit margin is compared with the group profit margin, to identify whether this rate is in line with the group as a whole.

- The approach from jurisdiction to jurisdiction is checked for consistency.

- Changes to the business, including restructurings, are examined to ensure the changes are adequately reflected in new transfer pricing policies and pricing.

Transaction basis

- The volume/value of intergroup transactions is analysed as a percentage of the company's activities.

- If there are significant intergroup transactions then further analysis is likely to be necessary.

- Transactions where substantial penalties are potentially liable are also reviewed.

- The methodology used for pricing the transactions is also reviewed – and atypical or non-OECD compliant methodologies selected for further examination.

Discussions with management

- The business's approach to transfer pricing and the investment made in establishing arm's length prices are evaluated. For example, who is responsible for transfer pricing (i) globally and (ii) locally? What is the in-house team's level of transfer pricing competence, and/or is the work outsourced to competent professional advisers?

- Are transfer pricing questions factored into the group's approach to business, *e.g.* tax sign off on changes to business operations, tax representation at operational strategy meetings, etc. The more involved the tax department is with operational changes the less chance of operations being out of line with transfer pricing policies.

- Is transfer pricing documentation up to date? What processes does the business have for ensuring (i) global consistency of pricing and (ii) adherence to local transfer pricing rules and documentation requirements? Current documentation is often an indicator of well-managed (and lower risk) transfer pricing.

- Does the business have Advance Pricing Agreements in place for key countries? Is the APA treatment consistent with pricing policies in other jurisdictions?

- Do the business's systems support analysis of arm's length intercompany transactions?

Annex E: Cloud computing

The term "cloud" has been around for a while as a simple metaphor to represent a complex information technology infrastructure. Originally used to represent the telephone network, the cloud symbol is now commonly used to represent the Internet. "Cloud computing" is a generic term for the delivery of information technology services over the Internet. Probably the most basic form of cloud computing service is the provision of data storage. The user files information over the Internet and it is stored by the third party service provider. The user no longer has to worry about backing up their data as that is part of the service and the data are generally accessible to the user wherever they are able to access the Internet. On the other hand the user generally has no interest in, and frequently no control over, where the service provider chooses to locate the servers on which their data are stored. That does not mean that this cannot be specified in any agreement with a service provider if a particular user is concerned about the location of their data.

Cloud computing services can extend well beyond the provision of data storage facilities over the Internet. There are three broad categories of cloud service provision. *Infrastructure as a Service* covers the provision of services such as data storage or access to server capacity that can substitute for the purchase of hardware. *Platform as a Service* takes the level of service further, replicating the functionality of an operating system so that the user is effectively provided with a virtual computing facility that is hugely scalable, something that is very useful for software developers. And the provision of *Software as a Service* gives the user the opportunity to access the functionality of various software applications via the Internet, without having to have copies of the applications on their own computer. E-mail applications such as hotmail and gmail are some of the most commonly used examples. But the applications available under this model are much more extensive than just e-mail, encompassing the usual suites of office applications (such as word processors and spreadsheets). They also include applications that in the past have been associated with the large corporate user, such as customer relationship management systems and enterprise resource planning tools. Acquiring these systems from a cloud service provider offers many advantages to the user, including no need to make significant capital outlay, the ability to scale up or down as the business requires and no need to worry about the maintenance of either the software or hardware. It also makes it possible for new businesses to acquire capabilities that would traditionally only be available to established enterprises with significant financial clout. Within the SME segment, businesses can now procure their record keeping and other business administration services from cloud service providers.

Cloud computing services are generally provided by third parties to users. However, the basic approach can be used within large international organisations to achieve economies of scale. For example, a large multinational enterprise might traditionally have procured hardware and software at a national or regional level, incurring capital and maintenance costs in several jurisdictions. Creating an internal "cloud" by means of an intranet enables the enterprise to manage its data storage and software applications once and in a single place, and so reduce the overall cost.

ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

The OECD is a unique forum where governments work together to address the economic, social and environmental challenges of globalisation. The OECD is also at the forefront of efforts to understand and to help governments respond to new developments and concerns, such as corporate governance, the information economy and the challenges of an ageing population. The Organisation provides a setting where governments can compare policy experiences, seek answers to common problems, identify good practice and work to co-ordinate domestic and international policies.

The OECD member countries are: Australia, Austria, Belgium, Canada, Chile, the Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Israel, Italy, Japan, Korea, Luxembourg, Mexico, the Netherlands, New Zealand, Norway, Poland, Portugal, the Slovak Republic, Slovenia, Spain, Sweden, Switzerland, Turkey, the United Kingdom and the United States. The European Union takes part in the work of the OECD.

OECD Publishing disseminates widely the results of the Organisation's statistics gathering and research on economic, social and environmental issues, as well as the conventions, guidelines and standards agreed by its members.

OECD PUBLISHING, 2, rue André-Pascal, 75775 PARIS CEDEX 16
(23 2012 14 1 P) ISBN 978-92-64-16907-4 – No. 59823 2012

Dealing Effectively with the Challenges of Transfer Pricing

Contents

Chapter 1. Introduction
Chapter 2. Selecting the right cases
Chapter 3. Getting off to a good start
Chapter 4. Governance arrangements
Chapter 5. Maintaining progress, tackling delay
Chapter 6. Reaching a decision point
Chapter 7. Resources, skllls and use of specialists
Chapter 8. Transfer pricing and developing countries
Annex A. Denmark
Annex B. South Africa
Annex C. France
Annex D. Transfer pricing risk identification and assessment: the perspective of an advisor of MNEs
Annex E. Cloud computing

www.oecd.org/tax

Please cite this publication as:
OECD (2012), *Dealing Effectively with the Challenges of Transfer Pricing*, OECD Publishing.
http://dx.doi.org/10.1787/10.1787/9789264169463-en

This work is published on the *OECD iLibrary,* which gathers all OECD books, periodicals and statistical databases.
Visit ***www.oecd-ilibrary.org***, and do not hesitate to contact us for more information.

OECD*publishing*
www.oecd.org/publishing

ISBN 978-92-64-16907-4
23 2012 14 1 P

