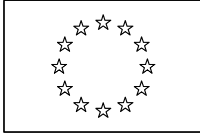

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EU JOINT TRANSFER PRICING FORUM

Private sector members' paper outlining corporate tax transfer pricing risk assessment and management approaches.

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1. Introduction

The JTPF convened on June 9, 2011. During the first meeting of the JTPF under the new mandate, it was agreed that agenda items for the term of the new mandate would include inter alia a review of Risk Assessment approaches. It was considered useful to exchange information on best practices and have an open and general discussion on these various approaches. The aim of this exchange was to gather information on potential avenues for the implementation of risk assessment tools. Risk assessment can assist in reducing transfer pricing related challenges for both Member States and Business. In order to investigate this aspect, both Member States and Private Sector Members of the Forum were asked to present on what transfer pricing risk assessment approaches they use, if any. The working paper that identified the agenda items for the new forum is Doc. JTPF 016/2011/EN and the draft summary record is contained in Doc JTPF 015/2011/EN.

The Private Sector Members discussed what risk assessment and risk management approaches are used in practice and concluded that the approaches used may vary rather significantly. Risk assessment approaches are necessary for several reasons. This can be because of applicable legal requirements, such as the Sarbanes Oxley legislation in the US, because of annual external audit requirements, or because of shareholder requirements, to mention a few. Some companies may implement and follow a very structured tax risk assessment system, which includes transfer pricing risk whereas others only take a “big picture” or “topical” approach to transfer pricing. Items often included in a risk assessment are: the availability of documentation, outcome of benchmarks, opinions and/or the impact on taxable income in an individual country. As mentioned these assessments are governed by Sarbanes Oxley, External auditor and other processes (like codes of conduct, tax policies and corporate responsibility).

The choice of tax risk assessment and tax risk management approach of a company, if any, depends on several factors such as:

(i) the size of the company and its business;
(ii) the number and size of international transactions that take place within the group;
(iii) the company’s tax policy;
(iv) the size and complexity of the transactions at hand; and
(v) any specific or peculiar demands of the (tax) legislation of the countries where the company conducts business.

The purpose of this paper is to provide a better understanding of how companies may assess transfer pricing-related risks and elaborate on what steps companies may choose to take to manage their transfer pricing risks. This paper focuses on transfer pricing risks, not on other tax risks.

2. Key risks in the area of transfer pricing

Transfer pricing reflects business transactions, and the tax department of a company is highly dependent on business information and business input to be able to manage transfer pricing-related risk. Transfer pricing risks largely stem from perceived or actual non-compliance with the arm's length principle and are likely to affect the company's tax position in two or more States. As audits often relate to years that have already gone by, one important risk aspect is that relevant information to business transactions related to those years may not be (easily) available anymore. Key employees may have retired or left, systems may have been upgraded and not allow for easy access to the previous systems, legal entities may have been disposed of or merged, acquisitions may have been integrated. All of these aspects may affect the availability of relevant information to substantiate the arm's length nature of the business transactions conducted in the years subject to an audit. The potential consequences of transfer pricing-related tax adjustments are well known and may include:

- Temporary or permanent double taxation;
- Additional tax on the adjustment;
- Penalties, interest and administrative charges;
- Lack of certainty and predictability over long periods of time;
- Costly and time consuming disputes;
- Large administrative burden;
- Requirement to change tax policy and related budgets;
- Withholding tax on deemed dividends;
- Negative publicity.

These adverse effects are becoming increasingly cumbersome and impose a notable impediment towards economic efficiency. From a practical business perspective, a number of factors contributing to this development, many related to changes in the global economic landscape, are being observed:

- The international economic environment: large public debts and the need for fiscal consolidation seem to translate into increased tax base protection. This is a likely contributor to the increasing number of transfer pricing disputes observed by businesses both within and without the EU.
- Lack of homogenous application of the arm's length standard: there has been a significant and rapid shift in the economic focus in particular towards the BRIC-countries, where the OECD-principles in the area of

transfer pricing often are given little or low relevance. By way of example, instead of the arm's length principle, safe harbour rules are sometimes used. Likewise, the view on principal business or supply chain models, compensating adjustments, treatment and ownership of intellectual property, availability of dispute resolution, etc. may vary considerably, frequently creating irresolvable transfer pricing disputes.

- Operative vs. legal structure: whereas businesses operations are increasingly global, taxes are still jurisdiction-based and levied locally on an entity-by-entity basis. Businesses are often structured regionally or globally and operate with relatively limited concern for borders or legal entities. As a consequence, the operative structure often appears wholly or partly detached from the group's legal structure. Tax and transfer pricing legislation is often not equipped to cope with the operational facts and business reality of a multinational corporation.
- Transfer pricing adjustments may affect customs and vice versa. However, there still is a stark lack of coordination in this field, leading to situations where transfer pricing adjustments that reduce the intercompany cost of goods sold do not qualify for customs duty refunds. Also, there is double (and costly) administration, as transfer pricing and customs use relatively similar valuation mechanisms but do not yet accept each other's valuation methods and studies.
- Courts as valuation institutes : courts typically resolve legal disputes whereas transfer pricing disputes often boil down to the application of valuation and economic theory and thus, are more often factual disputes. Courts are often insufficiently equipped to resolve transfer pricing disputes in a practical and satisfactory way.

Often overlooked is that transfer pricing controversy is costly for companies. Not only because of the tax on the actual transfer pricing adjustment and possible penalties and interest, but also because of the following factors:

- Management time (time not spent on core business);
- Time of tax, legal, Finance and other business departments;
- Cost of external advisors;
- Provisions (money kept on a bank account, not used to invest and frow the business);
- Uncertainty (influencing corporate decision making and investment behaviour);
- Relationship with tax authorities;
- Cost of part of annual audit by external auditors/accountants.

3. Risk assessment and management approaches

3.1 General

The purpose of this section is to give a general overview of some key elements of risk assessment and of some of the existing management approaches. To this end, the section is organized as follows:

1. Firstly, the company tax management function is generically described. This function may obviously differ from company to company depending on how large the company is, how complex and voluminous its transactions are and how many international intercompany transactions take place. Transfer pricing may be part of a general day-to-day tax management function but may also be a separate management item handled by a designated director of transfer pricing.
2. Secondly, factors (and information) that are relevant for assessing transfer pricing risk and managing such risk are identified.
3. Thirdly, transfer pricing risk assessment and management systems or approaches are identified (internal organization, tracking and/or reporting systems).

It is important to note that not having a defined transfer pricing risk assessment and/or management system does not in any way indicate that a company is somehow not complying with the arm's length standard. Depending on a company's size, the low level of complexity in its business set up, or other factors, it may not be feasible to manage transfer pricing risk as a separate function. Those companies that do not separately manage transfer pricing risk may very well have their transfer pricing based on sound business principles and in compliance with the arm's length standard, corroborated by transfer pricing, economic studies and/or appropriate documentation, however.

3.2 The Corporate Tax Function

The corporate tax department is essentially a service centre that is responsible for the company's tax and or transfer pricing policy. The corporate tax department usually reports to the Chief Financial Officer (CFO) or the company's General Counsel (either directly or via a "dotted line").

Items that may be included as responsibilities in the tax management function range from:

- developing, implementing and monitoring the group's transfer pricing policy

- tax compliance
- tax planning and business support (i.e. providing input to business proposals from a tax perspective)
- tax risk reporting
- tax and or transfer pricing policy
- assisting with project management and subcontracting
- driving and/or assisting with tax authority audits and litigation
- collecting and providing data for financial accounting, project accounting project controlling and legal departments within the organisation
- indirect tax reporting and compliance (HR, VAT/Customs). See: tax compliance
- Identify uncertain tax positions for financial reporting

Below, in particular the audit and litigation aspect is elaborated on.

Tax authority audits and litigation

The tax department is usually responsible for co-ordinating and ensuring compliance at reasonable cost with all worldwide tax authority audits. Depending on the organizational status of the tax department, it also includes deciding how to act if the audit materializes to a dispute between the authorities and the company. Examples of the responsibilities related to audits and disputes include:

- Coordinating the gathering and compilation of information needed to respond to requests from tax authorities in connection with corporate and other tax audits;
- Supervising the preparation of memoranda, protests and other documentation supporting issues raised during a corporate tax or other tax audit and on appeal;
- Preparing responses to miscellaneous correspondence from tax authorities;
- Preparing decision materials and/or deciding on how to resolve a dispute (MAP, litigation, alternative dispute resolution, dropping the issue etc.)
- Driving and/or coordinating the MAP, litigation processes etc.
- Assisting with follow-up as needed to help avoid double taxation, such as through arbitration under a Treaty for the Avoidance of Double Taxation or the EU Arbitration Convention.

The tax management function

The tax department is essentially a service centre that is responsible for adhering to the company's tax policy and having the company adhere to the applicable tax laws. It is not a profit centre within the MNE.

Items included in day-to-day tax management range from collecting data, tax planning and business support, tax risk reporting, tax compliance to assisting with tax authority audits, usually for a wide range of taxes, such as for corporate, employment and indirect taxes. The day-to-day tax management function is generally so diverse that, although it may include some transfer pricing risk assessment and related risk management, it often does not tailor specifically or exclusively to that responsibility.

3.3 Assessing and Managing Transfer Pricing Risk

Transfer pricing adjustments tend to have unwanted consequences. As transfer pricing adjustments invariably regard related party transactions, they typically affect the financials of related companies and tend to result in temporary or permanent double taxation. In addition, they can include penalties and administrative charges that would otherwise not have been incurred. Both stake a claim on scarce resources and the company's liquidity. The sensational reporting of a transfer pricing dispute in the press can taint or damage the corporate reputation, and trigger audits. Addressing transfer pricing adjustments by way of administrative objections and/or formal appeals can be costly and time consuming and present an undue administrative burden. For these reasons, identifying, assessing and managing potential transfer pricing exposures make sense.

For long-term planning purposes, companies generally benefit from administrative and fiscal stability. Certainty and predictability as regards the company's tax costs are desirable for business. Transfer pricing adjustments present just the opposite. During the time of a dispute, amounts may have to be held in reserve of which it is uncertain when they can be released. Furthermore, adjustments in one country may trigger additional reviews or even a new tax audit in another country. The resulting lack of predictability is a risk that may transcend the time it takes to resolve the transfer pricing dispute in the country where the primary adjustment was made. Management of transfer pricing risk takes place in different phases: upfront when a transaction has not taken place yet, during implementation of a transaction and once the transaction has taken place/is in place.

<u>Necessary Information for transfer pricing risk assessment</u>
In order to assess and manage a company's transfer pricing risk, the tax department needs to have sufficient information and understanding about a number of factors that may be helpful in assessing transfer pricing risk and managing such risks if and when they are identified. For a transfer pricing risk assessment, depending on the applicable facts and circumstances, tax directors may wish to extract the following information from the combined company data,

to the extent available. It should be noted that in the interest of providing guidance, this list is “over-complete.” Not all items are necessary to be reviewed at all times:

- The countries in which the company engages in business;
- The group’s legal structure and applicable ownership percentages/interests in related companies;
- The group’s supply chain, indicating what functions are performed by the respective associated enterprises, branches or permanent establishments;
- The legal and economical ownership of key intellectual properties;
- Relevant R&D activities and the location where such activities are performed and the related costs are incurred;
- The target operating profit margins (or gross profit margins) and actual margins of the respective divisions or associated enterprises;
- The group’s material intercompany transactions;
- The applicable intercompany cost allocation mechanisms, if any, and cost allocated, (such as management costs) if any;
- Company costs that may qualify as shareholder costs/stewardship costs and where they have been incurred;
- The applicable cost sharing agreements, if any;
- The group’s intercompany financing activities;
- In cases of business restructurings, the business reasons and the relevant projected changes;
- Relevant rulings or memoranda including relevant references to discussions with tax authorities and advice or memoranda from counsel;
- In cases of business restructurings, where relevant, valuation reports or indications of projected value impact resulting from envisaged changes;
- The status of tax returns to be filed for the respective enterprises, branches or permanent establishments;
- A listing or overview of amounts held in reserve based on applicable legislation (FIN 48) or otherwise and the applicable rationale for the reserves;
- An overview of applicable thin cap requirements in the respective countries where the company conducts business;
- Any incentives that the company has applied for and that are granted in the respective countries where it conducts business;
- An overview of tax authority audits that are ongoing, the audit issue(s), the audit status (settlement/administrative or judicial appeal) and the relevant applicable statute of limitations within which action is required;
- A listing or overview of applicable unilateral or bilateral/multilateral APAs and their terms;
- A listing of MAP filings and the amounts in issue in terms of tax, penalties and interest, if any.

Actions that can be taken for transfer pricing risk management

Transfer pricing risk assessment, and in particular related risk management, is based on being able to extract the right information and having the right information available, so that the right information and background can be provided to the relevant stakeholders within and without the company, as necessary in the individual cases. These actions are to some extent internal and to some extent external. Taxpayers will often make strategic decisions as to when they want pro-active risk management or a more reactive/defensive approach. Not unimportantly, risk management also means educating business, working with IT, setting up information networks to know which intercompany transactions are taking place etc. As such, transfer pricing risk assessment and management often goes beyond having documentation and a proper tax analysis in place.

Transfer pricing specific risk management actions may include, but are not limited to, the following internal actions:

- Making sure there is transfer pricing expertise available/in place in the key locations and that the relevant transfer pricing people have sufficient exposure to the relevant leadership teams in the business plus the authority to be able to execute;
- making sure that appropriate training is available for people who need to know about transfer pricing;
- Preparing the information listed above as necessary for transfer pricing risk assessment purposes and to the extent not available;
- Implementing intercompany contracts with respect to material intercompany transactions;
- Making sure transfer pricing documentation is put in place as needed and required by law, and kept updated for the group;
- Making sure that control mechanisms are in place, so that information is readily available to substantiate the company's transfer pricing compliance;
- Monitoring customs and VAT challenges and audits, as those potentially may have significant transfer pricing consequences;
- Keeping an eye on market influences such as the economy, competitors and new developments that impact the company's supply chain structure and its local and/or overall profitability. Collect the relevant information in case significant changes or impact are expected for tax purposes and flag this with the CFO to assess if and what further action may be needed to safeguard against tax challenges down the line;

- Where rulings or APAs are involved and cover the years in issue, the above market or internal developments may lead to material consequences and it needs to be determined if action is required;
- In case of contemplated business restructurings, regular and close liaison is required with the business and early determination on whether advance consultation or rulings, APAs or opinions may be required and useful;
- Where an APA or similar ruling is in place, monitor and make sure that all critical assumptions are fulfilled on a current basis.

Transfer Pricing specific risk management actions may include, but are not limited to, the following external (pro-active risk management) actions:

- If the company is part of an enhanced relationship program, monitor whether market or internal developments lead to material consequences and disclosure is required;
- Where rulings or APAs are involved and cover the years in issue, and market or internal developments are expected to lead to material consequences, self disclosure may be required to avoid penalties;
- In case of contemplated business restructurings, advance consultation or rulings, APAs or opinions may be recommended.

Assessing and Managing Transfer Pricing Risk

Transfer pricing risk assessment and in particular related risk management is based on being able to extract the right information, giving the right information and background timely to the relevant stakeholders within and without the company.

Factors that are relevant for assessing transfer pricing risk and managing such risk can be grouped in either the category of (i) Necessary Information or that of (ii) Actions. The level and intensity required of both depend highly on the particular facts and circumstances. As to both of these, it should be noted that managing risk has different phases: upfront when a transaction has not taken place yet, during implementation and once the transaction has taken place/is in place.

3.4 Transfer Pricing Risk Assessment and Management Approaches

To be able to make transfer pricing risk assessments and manage the related risk, it can be useful if certain procedures and or approaches are implemented in the company's organizational system and tax function. As noted above, the scope and refinement of these procedures vary significantly depending on factors like the size of the business, the number and size of international transactions, etc. Risk assessment does not have to be computerized or laid down in one combined document to be functional. Depending on the company's general tax policy, some companies may wish to implement and follow a very structured tax

risk management set up where others may only take a “big picture” or “topical” approach, when it relates to transfer pricing.

Some key procedures and approaches often seen in practise are presented below:

- Developing and implementing a centralized transfer pricing policy for the group as a whole;
- Implement a consistent transfer pricing approach and consistent methods to substantiate the supply chain’s performance;
- Take steps to bridge the legal corporate structure with the operational corporate structure for transfer pricing purposes;
- Implementation of centralized and global transfer pricing documentation (that may or may not follow the EU Masterfile format);
- Regular monitoring of centralized and global transfer pricing documentation;
- Updating economic benchmark studies as necessary;
- Provide transfer pricing training for the relevant tax department personnel to stay current and educated;
- Ensure that the tax department personnel has a solid understanding about the business set up and operation to safeguard accurate decision making
- Recruiting staff with adequate transfer pricing competency that is responsible for managing transfer pricing compliance (and conduct the related risk assessment);
- Educating key divisions and practices on the company’s transfer pricing policy, strategy and the consequences and risks of transfer pricing inconsistencies and related tax adjustments;
- Uphold a structured tax risk reporting line from business to the tax department;
- Depending on the applicable tax and/or transfer pricing policy, if any, pursuit of APAs in key jurisdictions.

Transfer Pricing Risk Assessment and Management Systems

Some companies may wish to implement and follow a very structured tax risk assessment system where others only take a big picture or topical approach when it gets to transfer pricing.