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EU Joint Transfer Pricing Forum – Business Representatives

Transfer Pricing Documentation Discussion Paper

EU Joint Transfer Pricing Forum
Transfer Pricing Documentation

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EU Joint Transfer Pricing Forum
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Executive Summary

The EU Member States have recognised that double taxation as a result of transfer pricing adjustments is an unacceptable burden on internal market trade. The present situation, when each country has its own view on what is required for transfer pricing documentation, gives rise to many practical problems. Equally, a drive to harmonise by adding together the requirements of all Member States (as was seen in the development of the PATA documentation model) would be an unwelcome solution. Member States now have an opportunity to work together to establish a new standard in "best practice" for transfer pricing documentation.

There is an opportunity for the EU to influence the international debate in a different way: by providing clarity for businesses and tax authorities alike on what the purpose of good documentation ought to be; what it consists of; and what each party achieves as a result.

At the end of the day, resource constraints are likely to occur both at the side of the tax authorities and the taxpayers. Great care must therefore be taken in Member States deciding what they really need to request business to prepare by way of any documentation beyond that which is created as a routine part of business activity. In the interests of efficient use of resources, it is hoped that Member States will be pragmatic. As European States move closer together, business has little motivation to drive transfer prices in any particular direction. The single market (the Euro zone especially) is becoming much more coherent. Consideration should be given to removing documentation requirements and/or publishing safe harbours to cover situations where tax authorities face very little risk. For instance, there are many group subsidiaries acting as distributors or commission agents for sales of their parent company products. There are a very limited range of pricing options for such business and yet each one is required to go through the same burdensome process of documentation. This could be avoided if, on a voluntary basis, such companies established their policies, ex ante, in line with certain safe harbour approaches. Business would generally find this helpful and would accept restrictions (eg such safe harbours do not apply in transactions with tax havens).

A greater degree of realism is needed on the part of tax authorities with respect to data provided from overseas in support of local transfer pricing policies. An example here would be where the company sets its transfer prices by reference to publicly available data on margins earned by similar, independent, businesses. If public data is unavailable locally, it will inevitably be necessary to consult more widely, perhaps considering the EU data available. Attempts to validate transfer pricing in this way are sometimes rejected out of hand, even though there is no practical alternative. Similarly, margin data prepared on a pan-EU basis should be accepted across the EU unless it is clearly unrepresentative of the position in the state concerned.

Day to day commercial judgements are exercised by hundreds of business managers in each group working within general corporate policies. Their decisions are based on proper

economic and commercial conclusions with regard to profitability and cost price calculations necessary to run the business. The documentation of all these decisions, as far as it goes beyond the point necessary for the proper functioning of the business itself, is both impractical and adds no economic value to the business. It is argued that any request for such additional documentation should only be made, if required, at the time the tax return is audited; generally speaking transfer pricing documentation should be in line with the normal reporting/accounting systems that business finds necessary for its proper management and for annual financial reporting following approved public standards. This would avoid a great deal of wasted time and effort; in many Member States the present array of documentation requests include much information that is difficult to find and irrelevant to the business management – in such circumstances it is not surprising that business only does the work strictly acceptable to avoid adjustments and non-compliance penalties. However, the work done may not be of material value to the tax auditor.

In and of itself the existence of a different documentation package for each country may impact on the single market, but there is also a question over the effect of these rules on trade. If the effect is an onerous compliance burden for a transaction between Member States which would not exist within one, then recent judgements of the European Court would indicate that at least one of the fundamental freedoms may be infringed. Reference can be particularly made to the so-called "Lankhorst"[1] and other cases.

The test of "good" documentation is not whether a tax auditor needs to ask for further information. It is whether the auditor has sufficient information to identify the relevant intercompany transactions, make an assessment of the transfer pricing risk and frame further enquiries into matters of detail.

The burden of proof on transfer pricing matters should be with the tax authority in the first instance. This is not to say it cannot be reversed in cases of abuse or where the company is unable to demonstrate it has considered the arm's length principle in its intercompany transactions. Any documentation requirements should support this neutrality.

The reality is that the only way it is remotely practical to manage transfer pricing in a major multinational is for appropriate aggregations of transactions to be made and for broad guidelines on the setting and maintenance of transfer prices to be followed. Similarly, this is the only practical basis on which to conduct tax audits of transfer pricing.

Once an EU view on documentation standards is agreed, while Member States would be free to accept them or not, it is urged that no Member State should create a further, alternative view.

[1] Lankhorst-Hohorst GmbH, European Court of Justice, C-324/00, decision issued December 12, 2002.

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1 Introduction

There is considerable controversy surrounding the issue of transfer pricing documentation. To identify just some of the problem areas, business and tax authorities disagree over the need for it, what it should contain and when it should be prepared. The two sides are driven by very different forces, of course. For the tax authority, preservation of the local tax base is paramount and transfer pricing is a critical element here. They want business to comply with the arm's length principle and to provide documentation proving this compliance. For business, the major concern is usually uncertainty over double taxation risks and the amount of work created by what seems to be an unacceptably high compliance burden. For the most part they wish to comply with the transfer pricing rules, file their corporate tax returns and have them agreed by the tax auditors without difficulty. The business community is of the strong opinion that the discussion on documentation requirements is without meaning if not going hand in hand with effective solutions on how to avoid timely double taxation for companies.

These objectives are not necessarily opposed and yet the two sides often appear to be in conflict. Where, then, lies the problem?

Furthermore, as more and more trade is handled by multinationals, transfer pricing has become more important to the maintenance of the tax base in each country. A number of countries now have penalty regimes, which can be applied to transfer pricing corrections made as a result of tax authority investigations. While double taxation agreements typically hope to relieve double taxation, penalties are an absolute cost to business. In the absence of clarity on documentation and its benefits, it is the desire to avoid penalties which has therefore driven business behaviour. Greater clarity may lead to a better result for both sides.

This paper attempts to identify the key issues associated with transfer pricing documentation, to provide a useful briefing to the members of the EU Joint Transfer Pricing Forum (EU JTPF) in forming their views.

2 The Documentation Problem

2.1 What is Transfer Pricing Documentation?

Transfer pricing documentation means different things in different countries even where the countries concerned are OECD members. The starting point is usually the OECD Guidelines [2] which contain a very thorough review of transfer pricing documentation in Chapter V. Unfortunately, its very breadth of coverage is at the root of the diversity we now see in transfer pricing documentation across the EU.

The guidelines provide "general guidance for tax administrations to take into account in developing rules and/or procedures on documentation to be obtained from taxpayers in connection with a transfer pricing enquiry" [3]. This "general guidance" is a long but non-exhaustive list of potential sources of information. While Chapter V urges tax authorities to ensure that their requests are reasonable relative to the matter under enquiry, the fact is that it is very difficult to identify resources of a kind which are not encompassed by the guidelines.

For business, Chapter V is a reminder that on audit, tax authorities are likely to seek access to considerable amounts of commercial information, often a nature which is quite different from that normally associated with a single corporate tax return. Much of it may not be held by the tax department or even be readily accessible by that department. It is possible that the information needed is in fact held by an overseas company of the group, leading to practical questions over access to the data and legal difficulties too. Consequently tax authorities should have no preconceived ideas that the additional information they require will be easily available from local commercial and management records.

Chapter V is a rich source of material for tax authorities. Depending on the nature of the local economy and the legal/tax climate generally, there are quite different expectations as to what business should be required to do in the area of transfer pricing documentation. As more tax authorities are reaching an independent view of what is reasonable or required, the burden on multinationals grows. There is no common definition of what constitutes transfer pricing documentation.

2.2 Documentation Rules

There is also a tendency towards somewhat prescriptive rules, specifying long lists of material to be produced by all companies affected by transfer pricing regardless of individual circumstances. For businesses, the problem is that the growing array of transfer pricing rules result in a compliance burden which is heavy and becoming more complex year by year, even when each country's rules might well fit within the guidance from the OECD. This is particularly frustrating within the EU's "single market".

[2] Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations published by OECD in 1995 with later additions.
[3] OECD Guidelines paragraph 5.1.

2.3 The Business Perspective

We have seen that Chapter V of the OECD guidelines illustrates the huge array of material that may well be relevant to a tax authorities in connection with a transfer pricing enquiry. From the business perspective this is confusing.

In addition, there is little comfort and certainly no guarantee that a significant investment in people and services to prepare sophisticated documentation will satisfy any tax auditor or, indeed, that it will be carefully considered during an audit. Here are some of the reasons:

- Tax auditors reading the OECD guidelines think about transactions. The group will have significant accounting personnel and systems which initiate and record transactions and eventually include them in annual accounts. In order to make sense of these hundreds of thousands of individual transactions from a TP perspective it is necessary to group them together, rather than isolate them. A tax auditor may want to dig deeper.

- It is unlikely that all aspects of a business will be checked by tax authorities to the same level of detail or even every year. If business tries to focus its work it may focus on areas the tax auditor chooses not to inspect in detail, but a completely exhaustive exercise on every area every year is impractical and would be prohibitively expensive.

- Day to day commercial judgements will be exercised by hundreds of business managers in the group working within general corporate policies. It may be important to capture these, but including them all in documentation would generate vast amounts of paper of questionable relevance to the overall assessment of whether pricing was acceptable or not.

These factors, together with the impact of penalties, means that transfer pricing documentation as proposed by business is often focused on the minimum effort needed to avoid material adjustment and penalties. This may be insufficient to satisfy a tax auditor looking for detail.

2.4 The Tax Authority Perspective

Tax authorities want access to information on a group's transfer prices. In a difficult and complex case they may indeed need access to all the various sorts of information listed in Chapter V of the Guidelines. Most recognise that this will not always be the case.

Tax authorities are also interested in driving taxpayer behaviour. They want taxpayers to have considered transfer pricing rules when setting prices and to have done this in accordance with the arm's length principle. During an audit they want to check whether this was in fact done.

As tax authorities have focused on this area, they have seized on documentation requirements and penalties as both a means of driving taxpayer behaviour and ensuring ready access to the information they may need. As we have seen, the actual effect on taxpayer behaviour may not be quite what they intended.

Documentation also permits a simple approach to transfer pricing during tax audits – in countries with documentation rules there is an increasing tendency for tax auditors simply to demand the documentation. Sometimes nothing more is heard on the subject, sometimes more detailed enquiries follow. There is nothing overtly wrong with such an approach. Indeed, it highlights one very important function of good documentation: it allows a tax auditor to form a view on the likely risk to the tax base posed by transfer pricing in a particular case and to decide where to focus further enquiries.

2.5 The Effect of Different Rules

The problem with the different rules across the EU is that a business could find itself producing 15 (soon to be 25) different sets of documentation for transactions which are in essence of a similar nature across the single market, all of which have been generated from a single business model. Any one of the documentation packages may be onerous, the combination of 15 may be a very daunting prospect indeed.

In and of itself this may impact on the single market, but there is also a question over the effect of these rules on trade. If the effect is an onerous compliance burden for a transaction between Member States which would not exist within one, then recent judgements of the European Court would indicate that at least one of the fundamental freedoms may be infringed. Reference can be particularly made to the so-called "Lankhorst"[4] case where the European Court of Justice struck down Germany's thin capitalization rules as a violation of the European Community Treaty's clause on freedom of establishment because it discriminates against companies that borrow from related non-resident parties. Other cases are: the Futura Participations and Singer Case[5]. In this context, attention should also be given to the size of the business and the complexity of its transactions. Should Member States place equal burdens on SME's and subsidiaries of large multinationals? Perhaps a "reasonableness" test could be applied in assessing the documentation standards appropriate for different types and sizes of business.

2.6 Conflicting or Congruent Interests.

It should be apparent that the taxpayer and the tax authority have at least one common interest: limiting pointless enquiries. Quite apart from the frustration that is often involved, pointless enquires waste the resources of both sides. The use of documentation as a risk assessment tool for tax authorities may therefore be one of its most important functions.

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[4] Lankhorst-Hohorst GmbH, European Court of Justice, C-324/00, decision issued December 12, 2002.

[5] Af.C-250/95; ECR 1997, I 2471 and ff

If, on the other hand, tax authorities regard a documentation requirement as a cheap and effective way of generating all the information they might conceivably require then the interests of the two sides will conflict. Taxpayers object when they are forced to spend resources on exercises of limited or questionable relevance to their tax liability.

Tax authorities are ill-advised if they consider that a documentation requirement is an effective substitute for intelligent and informed enquiry into the facts and circumstances of any particular case. Documentation is a good tool for gathering information and a bad substitute for judgement.

Finally, documentation is what a tax authority obtains in the first instance. There is rarely if ever anything to prevent further enquiries from taking place once documentation has been read and considered. In principle and in practice, documentation is the basis on which tax authorities make an assessment of the transfer pricing position and the means by which they frame further enquiries.

The Business Community therefore emphasizes the need to address the issue of documentation at two levels:

1. the evidence which tax authorities could reasonably ask for in the context of the taxpayer being able to demonstrate that he gave proper consideration to the need for a comprehensive, coherent and consistent addressing of transfer pricing rules and guidelines and that he was not therefore negligent when filing his tax return; and

2. the larger volume of documentation which a sophisticated taxpayer with a complex business might regard as prudent to prepare in order to be able to defend himself in the event of a transfer pricing enquiry in individual circumstances or for particular activities.

3 Current Guidance on Transfer Pricing Documentation

The leading guidance on transfer pricing documentation is contained in Chapter V of the OECD Guidelines. As already noted, it offers a reasonable view on transfer pricing documentation, seeking to encourage balance between the interests of the tax administrations and business. It identifies a huge array of materials which might be relevant but sets no clear limits on the actual requirements for either tax authority or business. How, then, is this interpreted?

3.1 The Pacific Association of Tax Authorities (PATA)

The recent attempts by PATA to create a coherent structure of acceptable transfer pricing documentation for businesses around the Pacific rim have not moved the debate any further. The package recently produced is arguably the highest common multiple of the transfer pricing documentation rules for the participating countries, rather than the lowest common denominator hoped for by business. Such an approach within the EU is unlikely to resolve the issues identified in Section 2.

However, there is one area where PATA has been clear; the agreement notes that compliance with the PATA package should avoid any question of a taxpayer suffering a transfer pricing penalty. This is an important factor: it provides the taxpayer with an incentive to comply.

Of course, this is not quite the same thing as guaranteeing that the transfer pricing documentation will suffice for audit purposes, nor that there will be no adjustments as a result of an audit. A taxpayer attempting to prepare documentation that meets these requirements faces an even more challenging task.

The implications for the EU are two. First, some consideration of what incentives exist would be worthwhile. Second, it is necessary to consider just what a documentation set is intended to achieve.

3.2 The European Union

Moving back to the EU, most member states have some kind of guidance on transfer pricing documentation and its purpose. At the extremes of the spectrum are, perhaps, the UK and Portugal. For UK purposes, it is clear when the transfer pricing rules apply and this is broadly where the same party can exercise commercial control over the entities involved. Where transactions take place between connected parties, the taxpayer should be able to show in transfer pricing documentation that it had a reasonable basis for believing its transfer pricing was compliant with the arm’s length principle. This leaves some uncertainty, but allows the flexibility for companies to make reasonable decisions on what is relevant under the facts and circumstances that prevail.

Contrasting this with Portugal, parties can be connected for transfer pricing purposes simply through economic interdependence or through a 10% shareholding. The transfer pricing

documentation rules then provide an extensive list of materials which need to be prepared in all cases.

So which of these approaches is preferable? The UK approach requires the exercise of judgement and recognises that the size and complexity of each business and its transactions should be taken into account in determining the documentation needed. Arguably, this is more in keeping with the stipulations of the Guidelines.

The prescriptive approach illustrated by the example of Portugal appears to offer greater clarity, in that no subjective judgement needs to be applied in deciding what to do but at a significant cost to smaller companies or those with relatively straightforward transfer pricing issues.

However, these differences may simply reflect the fact that the burden of proof is firmly on taxpayer in the UK while on the fisc in Portugal (and of course this is the primary position in most Member States).

3.3 Incentives

In principle taxpayers have one very real incentive to prepare good and effective documentation: to minimise the extensive and time consuming exercise that a transfer pricing enquiry can be. However, this has always been true. Why, then, have tax authorities decided only relatively recently that documentation rules and penalties are required?

It is fair to say that the preparation of good and effective documentation has long been regarded as “best practice” by business for precisely the reason given above. What prevented many from acting was the cost–benefit analysis. The benefits were very difficult to define let alone quantify, and without guidance on what documentation should be it was always difficult to decide what level of cost would buy any given level of benefit.

The evidence is that tax authorities have sought to influence this analysis by defining what they consider to be good documentation and by making the costs of non-compliance sufficiently stringent that the benefits of compliance (or, more precisely, the avoidance of penalties) outweigh the costs of performing the exercise.

There is an opportunity within the EU to influence the analysis in a different way: by providing some clarity for businesses and tax authorities alike on what the purpose of good documentation ought to be; what it consists of; and what each party achieves as a result. Indeed, at the end of the day,resource constraints are likely to occur at the level of both the tax authorites and the taxpayer. Therefore practical solutions are welcomed. Furthermore, use should be permitted of “safe harbours” in appropriate circumstances (see also paragraph 6).

3.4 Achievement

It has been shown that one primary benefit for both parties is an effective risk assessment system. However, for the parties to achieve that benefit two things are required. Tax

authorities must be prepared to give due consideration to the facts and analysis in the documentation. Taxpayers must be prepared to produce documentation in good faith.

The nature of a tax audit is often such that in the absence of outside intervention these two requirements will fail. Tax authorities seeking to generate additional taxes will disregard documentation that does not help them in their aim. Taxpayers, uncertain that a good faith attempt to produce documentation will show any benefit, will seek a lower cost alternative.

Intervention is possible. If the EU were to set out what a tax authority may expect in terms of documentation and what a taxpayer that prepares it in good faith may expect in return, the benefits to both parties may be achieved with positive effects for the single market as multinationals can produce more consistent documentation to support their transfer pricing.

3.5 "Good" Documentation

It follows from the above that the test of "good" documentation is not whether a tax auditor needs to ask for further information. It is whether the auditor has sufficient information to identify the relevant intercompany transactions, make an assessment of the transfer pricing risk and frame further enquiries into matters of detail. These recommendations are in line with the "two level" approach as suggested above under 2.6.

4 Enforcement

For tax authorities, the main purpose of documentation is enforcement. To assist with this aim many apply penalties and the overall position is affected by the local position on the burden of proof.

4.1 Penalties

More and more countries now have rules which apply some kind of financial penalty if transfer pricing adjustments are made by tax administrations to taxable income as originally reported by the taxpayer. These penalties are broadly of three types:

- commercial interest for late payment of tax;
- interest at higher than commercial rates which may also be non tax deductible for late payment of tax; and
- separate, additional fines levied by tax administrations.

It is well known by business that transfer pricing is not an exact science but this view is not accepted sympathetically by many tax authorities. There will usually be a range of positions on any transfer pricing matter which will satisfy the arm's length standard and the Guidelines make it clear that this is the case.

Paradoxically, this lack of precision often means that transfer pricing represents a potentially fruitful area of enquiry for a tax administration. If it is hard for a taxpayer to prove its position is "right", then there may well be scope for an adjustment.

Germany has recently introduced a further development – that the tax adjustment itself be based on the least favourable assessment of the arm's length range from the taxpayer's perspective if its documentation is thought to be insufficient.

The network of treaties between EU member states provide some constraints on the overall risk of double transaction in that the mutual agreement procedures offer the prospect of amendments being made in one country to relieve the double taxation caused by a transfer pricing adjustment being made in the other. However, it was only the advent of the EU Arbitration Convention that offered business the certainty that they would not be doubly taxed in the single market. Yet this has been curtailed too, partly through legal difficulties with the Convention itself but also through a fear connected with penalties.

The Convention will not be available as a source of prevention where certain sorts of penalty have been awarded against the taxpayer. Furthermore, neither treaties nor the Convention protect the taxpayer against the cost of penalties.

4.2 The Burden of Proof

In most EU countries, the tax administration bears the burden of proof. Where this is not the case, for instance in the UK, it is relatively easy for the tax authority to keep transfer pricing documentation rules short and simple. UK rules demand that transfer pricing documentation should demonstrate that the taxpayer had reasonable grounds for believing that transfer prices were compliant with the arm's length standard. The nature and quantum of documentation may change, from case to case. The word "reasonable" allows flexibility, recognising that the size, complexity and geographical spread of each business is different.

In countries where the burden of proof is on the tax administration, the tax auditor will want to ask the same sort of questions and review the same evidence "because without adequate information the tax administration would not be able to examine the case properly"[6].

The guidelines express the hope that "both the tax administration and the taxpayer should endeavour to make a good faith showing that their determinations of transfer pricing are consistent with the arm's length principle regardless of where the burden of proof lies"[7].

4.3 Major Multinational Businesses

For major businesses, where transfer pricing exposures are usually the largest, transfer pricing for tax purposes has become a significant compliance problem within the EU. A typical multinational will be operating in every member state, it will control all or large parts of the supply chain from raw materials through to finished products, it will be achieving economies of scale in all aspects of its activities and will invariably be planning on a pan-European basis, across the single market, ignoring country boundaries completely for most commercial purposes. There will be many companies inside the group where a large percentage of purchases and/or sales are with the other members of the group.

To the highly integrated, centrally organised, pan-European business, transfer pricing is invariably a commercial irrelevance; management are interested in the end sale price of goods or services to third parties and in ensuring minimum cost in achieving these sales. They rely on accounting systems that look at the business as an integrated whole.

Nevertheless, hundreds of thousands of transactions between companies may happen each year, affecting indirect taxes and, through the creation of local statutory accounts, corporate income tax and transfer pricing.

The OECD Guidelines look at transfer pricing on a transactional basis and indicate that "it may be necessary in applying principles of prudent business management for the taxpayer to prepare or refer to written materials that would not otherwise be prepared or referred to in the absence of tax considerations"[8].

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[6] OECD Guidelines paragraph 5.2
[7] OECD Guidelines paragraph 5.2
[8] OECD Guidelines paragraph 5.6

The reality is that the only way it is remotely practical to manage transfer pricing in a major multinational is for aggregations of transactions to be made and for broad guidelines on the setting and maintenance of transfer prices to be followed. The reality is also that this is the only practical basis on which to conduct tax audits of transfer pricing.

5 How is Business Dealing with Transfer Pricing Documentation?

It is worth considering what the current network of different national requirements has produced in terms of the documentation prepared and available for the tax authorities when a tax audit begins.

5.1 Strategy

Responses by business to the burden of documentation compliance vary significantly. Some rather "black and white" characterisations are included here:

- Do nothing and await audit; it may never happen. This is a minority view, declining in popularity as more audits take place, but has a continued appeal where the benefit of producing documentation is uncertain.
- Do the minimum necessary to avoid penalties, covering only those countries where transfer pricing audit risks are perceived to be high. This has the advantage of accommodating both the uncertainty over the benefits of documentation and the basic need to provide information to tax auditors. It is often the first position taken when a group moves away from the first category because it is manageable and focused.
- Take a strategic view of the compliance process, managing it on a global or regional basis. This has the advantage of allowing a measure of cost control as well as accommodating uncertainty and providing for a degree of information for the tax auditors.

Most groups, certainly the major ones, are either in the final category or are moving towards it. Transfer pricing is a huge compliance issue for them as many companies within their structure will have a major part of their transactions with related parties. Because the preparation of a large number of separate and unique documentation packages is an uneconomic proposition, companies are increasingly driven into this last category.

5.2 Practicalities

The documentation process is typically strongly influenced in style by the group parent. Nevertheless, typical actions may include the following:

- Centralise as much of the process as possible. For instance, the preparation of material on the group as a whole, analysing group accounts, accumulating intercompany contracts, etc.
- Plan to prepare documentation focusing on major territories and transaction types, deepening the analysis where needed as time permits.

- Keep the functional analysis as consistent as possible, because an in-depth investigation of conditions in each and every country soon becomes unmanageable.

- Allow experienced transfer pricing resources available to the group to work with less experienced to ensure relevance and accuracy of materials being prepared and also to enable knowledge transfer, so that later years processes can be more efficient.

- Leverage from experience/prior work wherever possible.

- Centralise the review of any material prepared at a local level to avoid misunderstandings.

- Plan to "mechanise" future compliance when possible.

Steps such as these mean that, over time, a group will be able to prepare local country documentation from both local and central sources. It will typically take several years to get a global system in place and thereafter the problem becomes one of maintenance.

5.3 Implications of a Centralised Approach

In adopting a centralised approach, whether on a global or regional basis, companies are foregoing the potential benefits of local documentation, tailored to each national operation, because they cannot justify the cost in relation to the benefits they see. Tax authorities can try to force the issue by enacting detailed local documentation requirements and reinforcing them with a penalty system, but it is hard to see that this helps: in the absence of further guidance, the economic proposition for taxpayers is unchanged and the incentives or benefits of good documentation are still unclear.

There is no objective reason why a centralised approach should be contrary to the interests of a tax authority. From the steps often followed by multinationals engaged in this process, it is likely that documentation will be prepared by individuals with more experience of transfer pricing and with more information to hand than would be the case if it were prepared on a decentralised, national basis.

If the objective of the tax authority is information this should be to its advantage. This is only a disadvantage for the tax authority if the desire is that documentation expose weakness or ignorance. Since one of the main advantages of the centralised approach is the elimination of weakness in a group's transfer pricing and the effects of ignorance on the part of its employees, the national approach is unlikely to reverse the centralising trend.

5.4 Documentation Within the EU

In the absence of a consistent basis for preparing documentation within the EU, the complexity of the situation faced by businesses is likely to increase and with it the burden on intra-community trade.

There is an opportunity for the EU to intervene by setting out clear standards on documentation which should be to the advantage of tax authorities and taxpayers alike.

Establishing appropriate standards would help taxpayers comply because a consistent EU position would facilitate both the documentation process and the central administration of transfer pricing policies. This will make the cost-benefit analysis much clearer for companies and should reduce the burden on intra-community trade.

Such standards would not preclude tax authorities from making further enquiries beyond the information contained in the documentation, would not inhibit the tax audit process and, if they improve taxpayer compliance or the quality of documentation, should assist the tax authorities in their work.

6 Can Transfer Pricing Documentation Standards be Established within the EU?

Tax administrations operating on a national basis need to be satisfied that their tax base is being calculated correctly. The starting place for company taxation is usually the local company accounts. These will usually have been prepared by an in-house accounting department and subject to examination by the statutory auditors. Several years later, the tax administration will examine the whole position again in what is invariably a lengthy process, usually adversarial in nature and taking up significant resources within both business and administration.

If an adjustment to transfer prices is made, there is hope for the taxpayer that there will be compensating adjustments in the territory at the other end of the disputed transactions. However, many years will have passed by the time this happens and the economic value created in the EU will not have changed at all. There will, however, have been a shift in tax revenue from one country to another. The taxpayer may well be indifferent to this. They will not, however, be indifferent to any penalties charged, nor to the financing costs of the double taxation or to the resources expended on the audit and then resolving the dispute.

Establishing appropriate standards for documentation, setting out what tax authorities and taxpayers may legitimately expect can only serve to assist the process and reduce the costs inherent in the current system.

As long as national taxation is paramount within the EU, tax administrations will have an interest in examining transfer prices to see if they can enhance their share of the tax base. The levying of penalties for “incorrect” behaviour is part of this. For business, it is accepted that transfer pricing audits will happen and will be unpredictable as to scope or location. At a minimum, therefore, businesses will plan to have enough transfer pricing documentation to avoid penalties. A common framework for documentation will enhance compliance and assist in the process.

The paper on corporate tax reform within the EU offered a number of alternatives to the status quo and in many areas there was perhaps an implication that the arm’s length pricing could become irrelevant and transfer pricing documentation with it. However, it seems unlikely that radical reform will be seen in the near future. For business, however, commercial efficiency continues to be paramount in this highly competitive world. Many major corporations have reviewed the possibilities of operating in Europe through the Societas Europa when this becomes possible. The setting aside of numerous layers of corporate activity and adopting a single company to reflect the enterprise wide management that is in fact taking place, is a very powerful idea.

At present, the uncertainties over the attribution of income to the many permanent establishments which would exist are seen as too great to move to this structure, despite the significant commercial savings which can be obtained. Consistent documentation standards

would apply equally to the attribution of income to such establishments and may help remove a major element of this risk.

With tax rates broadly in line across the EU and growing coherence of the tax base, the prime objective of business is the avoidance of double taxation.

In reviewing transfer pricing and transfer pricing documentation generally, it will be worth giving thought to just how efficient the tax system might be and how much overhead could be removed. (Of course, there may well continue to be difficulties in dealing with non-EU countries involved in intercompany transactions). Included below are a few matters for thought in the narrow area of transfer pricing:

- Transfer pricing is not an exact science. Is it appropriate that tax penalties should be applied to intra EU transfer pricing adjustments? It has been shown that the main purpose for such penalties is to drive the behaviour of multinationals and that there are alternative means to influence behaviour.

- Consideration should be given to removing documentation requirements and/or publishing safe harbours to cover situations where tax authorities face very little risk. For instance, there are many group subsidiaries acting as low risk distributors or commission agents for sales of their parent company products. There are a very limited range of pricing options for such business and yet each one is required to go through the same burdensome process of documentation. Generally, considerable efficiencies could be obtained in appropriate circumstances, if on a voluntary basis, such companies established their policies, ex ante, in line with certain safe harbour approaches. Business would generally find this helpful and would accept restrictions (eg such safe harbours not to apply in transactions with tax havens). Another example relates to intercompany service charges where a good deal of tax authority attention is often focussed for little or no adjustment. In this case it seems highly likely that broad principles could be easily established both for the transfer pricing methodology and the acceptable margins involved.

- A greater degree of realism is needed on the part of tax authorities with respect to data provided from overseas in support of local transfer pricing policies. An example here would be where the company sets its transfer prices by reference to publicly available data on margins earned by similar, independent, businesses. If public data is unavailable locally, it will inevitably be necessary to consult more widely, perhaps considering the EU data available. Attempts to validate transfer pricing in this way are sometimes rejected out of hand, even though there is no practical alternative. Similarly, margin data prepared on a pan-EU basis should be accepted across the EU unless it is clearly unrepresentative of the position in the state concerned.

- Blanket documentation exemptions could be considered for smaller business.

- Attention could be given to harmonising the differing documentation needs of the direct and indirect tax authorities.

Once an EU view on documentation standards is agreed, while Member States would be free to accept them or not, it is urged that no Member State should create a further, alternative view.

7 What Might Tax Authorities do Differently?

We have seen that the OECD Guidelines include just about everything in the definition of material that might be relevant in the documentation of transfer prices. We have also noted that business generally complies only so far as is necessary to avoid material risk and therefore further work is invariably needed if a transfer pricing audit takes place and the documentation initially prepared may, in such cases, be of little value. Certainly, it is prepared only for tax purposes and serves no other business purpose.

A number of tax authorities have realised that they do not have the resources to check everything and that they should fulfil their obligations by considering risk. In deciding which company to audit or which element of a business to examine, they should be motivated by the questions, "How much is at stake in the transfer pricing area?" or "What is the likelihood of material errors in this case?"

A transfer pricing questionnaire prepared specifically to gather data and prepare a risk assessment could help companies focus on necessary improvements in their transfer pricing system and make the tax audit process more efficient. Such a process should mirror that followed by a diligent and prudent business manager, who will be concerned to follow the arm's length principle. The existing procedures gather data for a tax inspector to evaluate. By creating instead a document which is focused directly on risk areas, the whole process should become much more efficient. It would also assist in getting tax authorities to recognise the concept of materiality more easily.

This risk assessment questionnaire coupled with intelligently applied safe harbours could provide an incentive to business to comply with the arm's length principle. Current rules and practices simply provide threats of penalties and double taxation. Surely the aim should be no double taxation or penalties coupled with minimal compliance costs.

It is hoped that tax authorities will recognise that developments in the area of documentation must be made as part of an integrated solution to ensure the avoidance of double taxation in connection with transfer pricing.

Tax authorities should also consider the issue of language (which is about to become more important with the accession states). It may not always be necessary for materials to be translated into a local language – statutory requirements may demand it but local language skills may render it unnecessary. Countries should publicise their potential areas of flexibility.