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EU JOINT TRANSFER PRICING FORUM

Discussion Paper on further Work in the Area of Transfer Pricing Risk Assessment

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Contact:
Jean-Marc Van Leeuw, Telephone (32-2) 29.58.936
Hartmut Förster, Telephone (32-2) 29.55.511
E-mail: taxud-joint-transfer-pricing-forum@ec.europa.eu

Commission européenne/Europese Commissie, 1049 Bruxelles/Brussel, BELGIQUE/BELGIË - Tel. +32 22991111
Office: SPA3 8/025 - Tel. direct line +32 229-55511

hartmut.forster@ec.europa.eu

1. INTRODUCTION

1. Risk assessment figures in the JTPF work programme 2011-2015. At the JTPF meeting of June 2011, members agreed that with respect to future work on Transfer Pricing risk assessment, it would be useful to exchange information on best practices in this area and have an open discussion on the various approaches. It was, however, recognised that it would be unlikely that binding conclusions or recommendations could be formulated. The aim would rather be to collect and share information on risk assessment tools and their implementation.

2. It was agreed that the Forum would hear presentations on risk assessment from the UK, The Netherlands, Austria and from Private Sector Members. No confidential information would be released by presenters; the focus would rather be on rules and practice.

3. At the JTPF meeting in October 2011, the first two presentations on risk assessment were made by Private Sector Members and by The Netherlands. At the JTPF meeting in March 2012, Austria and the UK presented their approaches to risk assessment to the Forum. Due to time constraints, it was not possible to discuss the presentations, nor the topic itself or a possible way forward. The discussion was postponed to one of the following meetings. Given that risk assessment is/was also addressed at other fora, the Chair asked the Secretariat to prepare a paper summarizing the current state of play including e.g. a summary of what is/has been undertaken at OECD/EU level and perhaps some proposals for a potential scope (if any) for an EU approach.

4. This document has been drafted based on the Chair's suggestion at the JTPF meeting in March 2012. The document addresses the background of the discussion on eventual work on transfer pricing risk assessment, presents areas where work may be done, possible approaches to this work and a brief state of play of transfer pricing risk assessment in the EU and other bodies.

2. GENERAL

5. The presentations given at the JTPF meetings in October 2011 and March 2012 already went beyond the pure assessment of risk. They addressed the broader context of what to do when risk is assessed and how to create the administrative framework for assessing risk. It is therefore suggested to use the term "risk management" rather than only "risk assessment".

Q1:

Do you share the view that the discussion should be broadened to transfer pricing risk management rather than limited to the pure assessment of risk?

2.1. Definition of risk management

6. Risk management can generally be defined as a formal process whereby risk factors for a particular context are systematically identified, analysed, assessed, ranked and provided for. In the context of transfer pricing this would mean:

   - an analysis of the enterprises involved and the environment (tax laws, tax rates, industry sector specifics, etc.),
   - the identification of potential risks and the estimation of their probability of occurrence
   - the assessment of potential risks in qualitative and quantitative terms
   - ranking the potential risks, and
   - deciding finally what risks are to be addressed or provided for, based on their probability, the level of exposure and the cost effectiveness of reducing that exposure relative to other uses for the resources employed (opportunity costs).

2.2. Objectives of risk management

2.2.1. Perspective of tax administrations

7. For tax administrations, which do not normally have the resources to check everything, risk management could make the taxpayer selection and tax audit processes more efficient, i.e. it may be helpful in deciding which company to audit or which element of a business to examine, either by means of a specific inquiry or in a tax audit. Managing Transfer Pricing risk may thus help tax administrations to protect their tax base and use their resources more efficiently.

8. Risk management is also a useful tool to reduce variations in detecting non arm's length transactions among enterprises which result from auditor biases (including auditor experience) and therefore to achieve more equality of tax treatment for taxpayers.

2.2.2. Perspective of taxpayers

9. Identifying specific transactions where establishing an arm's length transfer price is most difficult and where tax administrations are likely to examine in depth, may help taxpayers to pro-actively concentrate on those transactions when making an effort to set their transfer prices at arm's length. These "risk" transactions may also require more detailed explanations and documentation to be made available in order to achieve the main objective of risk management for taxpayers, i.e. to avoid being exposed to double taxation and penalties as well as to reduce time consuming and costly subsequent disputes and their resolution. For taxpayers, a risk management could also help focus on necessary improvements in their transfer pricing system.

2.2.3. Common perspective

10. The objective of risk management should be to enable a business or a tax administration to establish what amount of effort and cost is appropriate in establishing, in particular circumstances, what the "arm's length" result of a transaction between associated enterprises should be and how evidence should be kept to demonstrate that result. This would enable a business to judge what resources to devote to keeping documentation in relation to particular transactions and a tax administration to judge what resources to devote to auditing those transactions. In other words, risk management enables both tax administrations and business to allocate and use their scarce resources as efficiently and effectively as possible.

> **Q2**:
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> Do you generally agree to the definition and objective of risk management as elaborated above?

3. Work undertaken/in progress

3.1. Presentations at the EU JTPF

11. At the JTPF meetings in October 2011 and March 2012 presentations on risk management were made by PSM, The Netherlands, Austria and the UK[1]. The presentations were focussed on various aspects in the area of risk management.

12. The presentation by PSM addressed the broader context and value of risk assessment as well as some of its key elements. The Netherlands' presentation placed Transfer Pricing risk management in the context of their approach of enhanced relationship with the taxpayer. Austria and the UK presented their approaches for case selection, pre-audit analysis, approaches used in audits for identifying high risk areas as well as some organisational aspects that they have considered in their tax administration.

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3.2. Work undertaken at EU-level

13. The EC's Fiscalis Risk Analysis Project Group in 2006 published a Guide on Risk Management for tax administrations[2]. This Guide has been developed in order to provide a common foundation for decisions at all management levels within tax administrations. Further work has been done by tax administrations but it has not been published to date..

[1] The respective presentations are published on the JTPF's website.

[2] http://ec.europa.eu/taxation_customs/resources/documents/taxation/tax_cooperation/gen_overview/risk_management_guide_for_tax_administrations_en.pdf

14. The Guide is not specifically targeted at risk management in transfer pricing but rather addresses the various features of risk management that may be beneficial for tax administrations in general. The 2006 report describes the risk management process in general (identification, analysis and treatment), organisational factors and provides examples from various MS as well as technical details. Work has also been done on compliance risk management (process, influencing taxpayer behaviour, organisational aspects and examples from MS). ..

15. The 2006 Guide may serve as a basis for a future project on risk assessment and the project may evaluate whether and how those general measures/conclusions can be targeted to transfer pricing.

3.3. Work undertaken/in progress at OECD-level

16. The topic of risk assessment has been addressed at the level of the OECD's Forum on Tax Administration in its recent study "Dealing Effectively with the Challenges of Transfer Pricing"[3]. The report discusses ways in which the management of transfer pricing can be optimised so that transfer pricing audits and enquiries are conducted efficiently and in a timely manner.

17. The report concludes that effective risk assessment is essential and a number of techniques for identifying TP risks are discussed. The report addresses administrative issues and confirms the trend towards more real-time working of cases. Further transfer pricing programmes and capacity building is discussed. The report contains practical guidance as e.g. the approaches used by certain OECD countries to deal with transfer pricing risk or a list of features that may suggest Transfer Pricing risk

18. In March 2012 the OECD held its first Global Forum on Transfer Pricing. The next Global Forum on Transfer Pricing will be held in March 2013 and will focus on Transfer Pricing risk assessment. For this purpose a steering committee was created that will further address the issues in preparation of the next Global Forum. Further information on this project may be given by the participant from the OECD at the JTPF meeting.

3.4. Work undertaken/in progress at UN level

19. The UN's Subcommittee on Transfer Pricing is working on a practical manual on transfer pricing for developing countries. A draft of this manual is published on the UN's website[4]. Chapter 10 of this draft manual deals with practical aspects of transfer pricing audits and risk management. It addresses organisational features of Transfer Pricing audits, various approaches that may be used for the selection of taxpayers for transfer pricing examination,

[3] The publication can be downloaded at the OECD's website: www.oecd.org

[4] http://www.un.org/esa/ffd/tax/documents/bgrd_tp.htm

the planning of the Transfer Pricing examination, the pre-audit and audit stage and how to focus on certain TP issues.

4. FEATURES THAT MAY BE ADDRESSED BY THE JTPF

4.1. General

20. The presentations made at the JTPF and the overview on the work undertaken/in progress indicate that with respect to the issue of transfer pricing risk management 3 main areas can be identified for which it may be worth considering further work to be done at the level of the JTPF. This work could be based on the material already available in the public domain and MS approaches/experiences and may especially evaluate the EC's Fiscalis Risk Analysis Project Group conclusions in the light of transfer pricing.

4.2. Selection of cases

21. Given the need for ensuring that tax administration's scarce resourses are used most efficiently, one important feature in risk management is the selection of the right cases for audit, i. e. cases where there is the highest risk of non-compliance with the arm's length principle. Several tools may be considered for this purpose.
22. Austria and the UK in their presentations presented several features that they use to identify cases that may be worth to be audited, e.g.

- time, i.e. whether and when the case was audited the last time,
- certain group criteria identified making it worth focussing audits on a certain group of companies/business sectors
- external suggestions and
- taxpayer specific features like for example business relations to companies in tax havens, losses over a certain period of time, or extraordinary expenses/income.

23. Another tool worth being considered and elaborated in a project could be the comparison of the taxpayer with other companies e.g. an analysis and comparison of financial ratios and other data available in the public domain about companies active in the same or similar business sector.
24. Future work on risk management may consider tools for identifying high as well as low risk areas and provide additional guidance for their use keeping in mind that this exercise would need to be distinguished from determining comparability.

Q3:

Do you support an evaluation of tools and practical guidance on the selection of cases?

4.3. Determining the focus of the audit

25. The UK in its presentation highlighted that further steps may be undertaken by a tax administration after a case has generally been selected but before the in depth audit actually starts (pre-audit stage). In this pre-audit stage certain measures could be taken internally and with the use of limited resources to identify whether the case is finally worth of being audited and if so on which transactions the audit should focus.

26. If this pre-audit stage results in the need for further examining the case, a further area where risk management plays an important role is the determination of which specific transactions should be audited in depth. Here certain triggers may be developed and suggested that may indicate the need for a more in depth audit.

Q4:

Do you support an evaluation of tools and practical guidance on determining the focus of an audit?

4.4. Administrative measures

27. Effective risk assessment requires the existence of an administrative framework in which the respective measures can be taken. The future work may address measures that could be taken by a tax administration on how to build up/improve the administrative framework. The scope of this work may reach from internal organisation of audit procedures up to questionnaires that may have to be answered by taxpayers to assess their risk profile.

28. In this context the project may also elaborate on measures of enhanced relationship between taxpayers and tax administration as taken by some MS and presented by the Netherlands at the JTPF meeting in October 2011.

29. Another area that might be addressed is capacity building. Capacity building may relate to transfer pricing expertise as such but also to expertise relating to certain industry sectors. The latter may be helpful for enhancing the understanding of business sector related issues and transfer pricing risks

Q5:

Do you support an evaluation of tools and practical guidance on administrative measures?

5. FUTURE JTPF WORK

30. The work programme already recognises that it may be unlikely that binding conclusions or recommendations can be formulated. A good or best practice approach, which is the least prescriptive common approach, seems to offer advantages as regards flexibility. It would avoid the problems associated with standardisation, e.g. reaching agreement on a uniform risk assessment process or even risk assessment form. On the other hand, a standardised and, even more, a uniform risk assessment process would prevent fragmentation and reduce compliance burdens and provide taxpayers with more certainty, so it may therefore not be ruled out in principle.

31. Given the work done in particular by the OECD, it seems that additional value would only be achieved if the Forum is able to go beyond the general conclusions of the OECD and other bodies, by agreeing on certain recommendations and/or best practices.

Q6:

What do JTPF Members think about doing further work on risk assessment/management and the possibility of agreeing on recommendations and/or best practices?