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EU JOINT TRANSFER PRICING FORUM

DRAFT
REVISED SECRETARIAT DISCUSSION PAPER ON DOCUMENTATION REQUIREMENTS

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Working paper

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A. GLOSSARY

CODE OF BEST PRACTICE

The description of certain aspects of legislation, administrative rules and practices on documentation requirements applied by countries that Member States are recommended to follow. This is the least prescriptive common approach to avoid the fragmentation of documentation rules in Member States.

STANDARDISED DOCUMENTATION RULES

A uniform, EU-wide set of rules for documentation requirements according to which all enterprises in Member States prepare separate and unique documentation packages. This more prescriptive approach aims at arriving at a decentralised but standardised set of documentation, i.e. each entity of a multinational group prepares its own documentation, albeit according to the same rules.

CENTRALISED (INTEGRATED GLOBAL) DOCUMENTATION

A single documentation package (core documentation) on a global or regional basis that is prepared by the parent company or headquarters of a group of companies in a EU-wide standardised form. This documentation package can serve as the basis to prepare local country documentation from both local and central sources.

MASTERFILE CONCEPT

The "masterfile" concept is an enhanced version of the centralised, standardised documentation concept. A multinational group would prepare one set of standardised transfer pricing documentation that would consist of two main parts: (i) one uniform set of documentation containing common standardised information relevant for all group members (the "masterfile") and (ii) several sets of standardised documentation each containing country-specific information ("country specific documentation"). The documentation set for a given country would consist of the common masterfile supplemented by the standardised country specific documentation for that country.

B. BACKGROUND TO DOCUMENTATION REQUIREMENTS

I. Introduction and Context

1. EU – The Internal Market

1. The Commission study "Company taxation in the internal market" SEC (01) 1681 of 23 October 2001 identified high compliance costs and potential double taxation for intra-group transactions as a major tax obstacle to cross-border economic activities in the internal market. The study showed that compliance costs relating to transfer pricing mainly result from the obligation to prepare appropriate documentation and find comparables. The study concluded that, while there is evidence of aggressive transfer pricing by some companies, there are equally genuine concerns for companies which are making a bona fide attempt to comply with the complex and often conflicting transfer pricing rules of different countries. Such concerns are becoming the most important international tax issue for companies.

2. Conversely, Member States are, for example, concerned that substantially different tax rates induce enterprises to shift income. With the accession of ten new Member States and the range of corporate tax rates becoming even wider (from 0% to 35% for retained earnings) this problem may become even more serious.

3. There is generally a tendency among EU Member States, fearing manipulation of transfer prices and double non-taxation, to impose increasingly onerous transfer pricing documentation requirements. Documentation requirements overall have increased within the EU in the sense that some Member States either by legislation or by circular letters have introduced documentation rules or tightened existing requirements and it can be expected that this trend will continue.

4. The mere existence of different sets of documentation requirements in the Internal Market (and its potential to expand to over 25) represents an additional burden for a company in one Member State to set-up and/or conduct business with an affiliated company in another Member State, and instead favours domestic investments/transactions. The preparation of a large number of separate and unique documentation packages is an uneconomic proposition and small and medium-sized enterprises can be particularly hit by these problems.

5. Business representatives strongly express the view that transfer pricing documentation requirements in the EU create unduly high compliance costs. Generally, it is said that they often go beyond the requirements which can be met by management accounting, thus creating a substantial and growing compliance cost for businesses (and tax administrations) involved in cross-border activities. Business also maintains that some Member States do not follow the OECD Guidelines in a coherent way and that there are significant differences in documentation requirements between Member States. Member States, on the other hand, argue that they often are unable to examine transfer prices due to non-compliance of taxpayers with documentation requirements.

6. Compliance with multiple documentation rules within the EU is challenging in a large part because of the jurisdictional variances of several key factors, such as

- substantive rules;
- penalties; and
- administrative policies.

7. The Commission's company tax study concludes that the compliance costs and the uncertainty could be reduced by better co-ordination between Member States of documentation requirements and developing best practices. A more uniform approach by EU Member States, within the framework of the OECD Guidelines, would also contribute to a stronger position in relation to third countries.

8. Some Member States are beginning to introduce transfer pricing documentation requirements also for domestic companies. In order to alleviate the compliance burden for domestic companies tax administrations might need to limit or reduce documentation requirements.

2. OECD – Transfer Pricing Guidelines (Chapter 5)

9. In addressing the issue of documentation, the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (hereafter called "OECD Guidelines") aim at maintaining a balance between the right of tax administrations to obtain from taxpayers as much information as possible to ascertain whether the transfer price is at arm's length, and the compliance cost that any documentation rules imply for the taxpayer. The OECD Guidelines recognize that the taxpayer should make reasonable efforts, at the time transfer prices are set, to determine whether the arm's length principle is satisfied, and that tax authorities can expect or require taxpayers to maintain documentation to support this.

10. To that effect, the OECD Guidelines provide a list of items, which are likely to be useful in most cases, and other types of information that will be useful in many cases. Given the specific nature of transfer pricing, i.e. the variety of cases and the different facts and circumstances of each case, the list is not exhaustive.

11. The OECD Guidelines do explicitly mention that enterprises are not required to use more than one transfer pricing method. They also state that there is no requirement for supporting contemporaneous documentation to be prepared either at the time the prices are set or when the tax return is filed (i.e. it is acceptable for it to be prepared only on request from the tax authorities).

12. Although the OECD Guidelines are a very helpful framework, they are sometimes considered too general and too vague, giving rise to different interpretations. For example, within the EU there are no consistent definitions, applications or enforcement of issues such as the following:

- acceptable transfer pricing methods;
- prioritising, selecting and applying transfer pricing methods;
- selection of comparables;

- standards of comparability; and
- determination of an acceptable arm's length range.

3. PATA – Experience with a Multilateral Documentation Package

13. In this respect, it might be interesting to note that the PATA (Pacific Association of Tax Administrators) including Australia, Canada, Japan and the United States, released on 12 March 2003 its final transfer pricing documentation package. This multilateral documentation package is intended to enable taxpayers to prepare – on a voluntary basis – a uniform set of documentation that would satisfy the transfer pricing documentation requirements in all PATA jurisdictions.

14. Taxpayers electing to apply the PATA documentation package must comply with three operative principles: (1) reasonable efforts, (2) contemporaneous documentation and (3) timely production. Furthermore, the PATA documentation package contains an exhaustive schedule of 48 items of information required, which represents substantially more documentation than that required by any individual PATA member country. This means that all participating companies must abide by the most stringent compliance requirements of each member country.

15. Particularly small- and medium-sized enterprises may, therefore, be forced into onerous and expensive documentation compliance burden. However, SMEs do not have the time, budget or resources to comply with such extensive documentation requirements

16. Moreover, such a specific, exhaustive list as PATA proposes would also require many companies to produce documents that are irrelevant to determining an arm's length transfer price. In many cases this would be disproportionately time-consuming and costly for companies.

17. Since the PATA documentation package does not protect taxpayers from transfer pricing adjustments and subsequent double taxation, it is of only limited use.

18. The lack of sufficient involvement of business in drawing up the PATA package may explain the criticism from taxpayers. There is, however, one benefit of the PATA agreement: it notes that compliance with the PATA package would protect a taxpayer from a transfer pricing penalty. This is an important factor because it provides the taxpayer with an incentive to comply.

II. Purpose of this Paper

19. A common approach to the issues related to documentation requirements throughout the EU is essential in order to make progress at EU level on reducing uncertainties, compliance burdens and the risk of double taxation, and on promoting the single market. JTPF Members should, therefore, seek to reach consensus on the preferred approach. Four different concepts are discussed in chapter D of this paper:

(i) a code of best practice;

(ii) a set of EU-wide standardised documentation rules;

(iii) centralised (integrated global) documentation; and

(iv) a masterfile concept.

20. In reviewing transfer pricing documentation generally, the interrelation of a common or standardised approach within the EU with different documentation requirements in non-EU countries has to be taken into consideration. A consistent EU approach will, of course, not bind third countries but in setting a good example it may influence the legislation and administrative practices in non-EU countries.

21. On the other hand, problems with different documentation requirements will persist for multinational enterprises doing business outside the EU. They will generally still have to prepare separate documentation packages for EU and non-EU purposes.

22. Another aspect to be examined is the scope of a consistent EU approach, i.e. which entities of a multinational group of companies doing business beyond the EU should be covered. It seems clear that all group entities resident in the EU should follow the EU approach. However, problems could arise, in particular with respect to a centralised approach, where an EU company is an associated enterprise of a non-EU company.

23. This paper intends to guide the discussions in the FORUM with a view to reach consensus on a common approach in developing rules and/or procedures on documentation requirements. It attempts to provide 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 may achieve as a result.

24. More particularly, this paper should help the FORUM to identify what a tax administration may legitimately expect in terms of documentation and what a taxpayer that prepares it in good faith may expect in return. To this effect the paper attempts to develop a common approach (including questions of language) in setting up documentation standards of which both business and national tax administrations could benefit in terms of transparency, reduction of compliance cost (in particular for SMEs) and improvement in taxpayer compliance. The benefits to both parties may also lead to positive effects for the single market.

25. From the taxpayers' perspective the most important goals of the proposed recommendations set out in this paper are:

- to assist taxpayers to efficiently prepare and maintain useful transfer pricing documentation;
- to respond to the difficulties that enterprises in EU Member States face in complying with the laws and administrative requirements of multiple jurisdictions; and
- to avoid the imposition of transfer pricing documentation-related penalties on taxpayers.

26. For example, establishing a common framework for documentation would help taxpayers comply because a consistent EU position would facilitate both the documentation process and the central administration of transfer pricing policies.

This would reduce taxpayers' compliance costs and record keeping tasks that constitute a burden on intra-community trade.

27. Another reason for seeking a common EU approach on documentation requirements is the important concept of the prudent business manager in the documentation chapter of the OECD Guidelines. This concept states that the process of considering transfer prices should be determined in accordance with the same prudent business management principles that would govern the process of evaluating a business decision of the same complexity and importance. Business claims that this implies that tax administrations cannot expect taxpayers to devote more resources to setting transfer prices at arm's length than they would for other aspects of their business.

28. The level of documentation should, however, reflect the complexity and importance of the controlled transactions. In that context, the OECD Guidelines state in para. 5.4 that "…the application of these principles will require the taxpayer to prepare or refer to written materials that could serve as documentation of the efforts undertaken to comply with the arm's length principle…" Tax administrations take the view that the prudent business management principle also implies that an enterprise prepares its documentation within a reasonable time frame.

29. The practical application of the prudent business management principle is difficult, but this makes it all the more important that Member States adopt the same approach, not least because this principle implies that there is a prudent business manager on each side of a transaction.

30. Multinational enterprises, in principle, favour integrated global documentation for tax purposes. The main reason given for this is that an integrated approach provides consistent documentation. However, many multinational enterprises, in practice, do not apply such a global approach. One of the main reasons for multinational enterprises not taking a global approach is the different documentation requirements (including questions of language). The existence of a common EU documentation guidance would serve as a major incentive for business to prepare EU and, as necessary, global documentation. Moreover, such guidance on common EU documentation rules would help in finding an agreement on documentation requirements in the international context, not least at OECD level.

31. Multinational enterprises are often active in both the EU and other (OECD) countries. It is, therefore, important that common EU documentation requirements do not interfere with the OECD Guidelines. The proposed recommendations hereafter are, therefore, based on the OECD Guidelines and are intended to complement these Guidelines and not to hamper more global solutions within that particular OECD framework.

32. The proposed documentation standards shall not preclude tax administrations from making further enquiries beyond the information contained in the documentation. Also, they shall not inhibit the tax audit process. If they improve taxpayer compliance and the quality of documentation, they will rather assist the tax authorities in their work.

33. In developing rules and/or procedures on documentation requirements it should be borne in mind that both taxpayers and tax administrations have legitimate concerns to which it is necessary to seek a balanced solution. Any compromise must,

therefore, take account of taxpayers' legitimate interest to reduce their compliance costs and to be less exposed to penalties and of tax administrations' legitimate interest to protect their tax base. Both sides share, however, the common interest to concentrate their resources on areas where there is more tax at risk.

III. Purpose of Good and Effective Documentation

1. Business point of view

34. The benefit of good and effective documentation for taxpayers is intended to be less time and expenses spent on preparing documentation and less risk of penalties. Businesses are, therefore, looking for pragmatic, user friendly solutions, not least, because staff applying documentation rules are not normally tax experts but operational staff.

2. Tax administration point of view

35. For tax administrations the purpose of good and effective documentation is to ensure that the tax administration has sufficient information to identify the relevant inter-company transactions and allow the tax administration to assess whether a taxpayer's transfer pricing is in accordance with the arm's length principle. The main benefit of good documentation is less complicated and time-consuming transfer pricing examinations.

3. Benefit of a risk assessment system

36. A transfer pricing questionnaire designed 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 the tax administration to evaluate. By creating instead a document, which is focused directly on risk areas, the whole process should become much more efficient. Such a risk assessment questionnaire could also provide an incentive to business to comply with the arm's length principle.

37. For tax administrations, which do not normally have the resources to check everything, making a risk assessment on the basis of a risk assessment questionnaire filled out by the taxpayer may be helpful in deciding which company to audit or which element of a business to examine. One of the factors that a tax administration may take into account in selecting a case for transfer pricing examination is its knowledge about the nature of the documentation produced by the enterprise.

38. In conclusion, an effective risk assessment system is beneficial for both tax administrations and taxpayers. However, to achieve this, tax administrations must be prepared to give due consideration to the facts and analysis in the documentation and taxpayers must be prepared to produce documentation in good faith.

IV. Content of Good and Effective Documentation

1. Evidence

39. As far as both enterprises and tax administrations are concerned, it is necessary to establish whether the pricing of any particular transaction satisfies the arm's length principle. This means there has to be evidence.

40. Chapter 5 of the OECD Guidelines contains a general discussion of both evidence and documentation and stresses the critical role of comparability (looking at equivalent transactions that have taken place between independent enterprises) in providing evidence. Evidence is stronger the more it is based on actual experience of transactions between independent enterprises.

41. The "prudent business management principle" implies that the sort of evidence that would be appropriate in relation to a transaction where a large amount of taxable profit was at stake might be very different from the sort of evidence that would be appropriate in relation to a transaction where much less taxable profit was at stake. Again, it is not possible to prescribe detailed rules on this point.

42. Given the nature of controlled transactions, it may be necessary in applying the prudent business management principle 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 (cf. para. 5.6 of the OECD Guidelines).

43. In order to allow the tax administration to make a determination if a taxpayer's transfer pricing is at arm's length, many Member States, including Member States where the burden of proof is on the tax administration, oblige enterprises to identify comparable third party transactions. Because of the difficulties in locating adequate third party transactions for which the comparability analysis can be satisfied, taxpayers as well as tax administrations frequently rely on publicly available data, e.g. from commercial databases. The use of database searches for comparables is discusssed in more detail in Chapter C below.

44. However, a coherent and transparent approach in identifying comparables is important in ensuring, for example, that there is no "cherry picking" to suit either the taxpayer or the tax administration. Moreover, the issue of transparency with respect to identifying comparables is equally important in MAPs between competent authorities.

2. Documentation

45. Taxpayers are obliged to determine transfer prices for tax purposes according to the arm's length principle and are expected to prepare and keep written documentation regarding how prices and conditions for the controlled transactions are set. The documentation must - on request - be presented to the tax administration and must be of a nature that enables the tax administration to assess whether the prices and conditions are set in accordance with what would be achieved if the transactions were concluded between independent parties.

46. A key issue for transfer pricing is, therefore, the question of what kind of documentation an enterprise needs to prepare to demonstrate it has applied the arm's length principle.

47. The OECD Guidelines say that the need for documents should be balanced by the costs and administrative burdens and that documentation requirements should not impose on taxpayers costs and burdens disproportionate to the circumstances. In other words, the amount and type of documentation required should be in proportion to the circumstances of each case. Especially for small and medium sized enterprises, the various documentation requirements impose an extra burden, certainly in the start-up phase of their international expansion.

48. The OECD Guidelines go on to say that it is not possible to define in any generalised way the precise extent and nature of the evidence or documentation that it would be reasonable for the tax administration to require or for the enterprise to produce for the purpose of an enquiry.

49. It could be argued, therefore, that Member States should avoid developing rules that are very prescriptive, specifying long lists of material to be produced by all companies affected by transfer pricing regardless of individual circumstances, because it prevents flexibility that could otherwise take account of the specific facts and circumstances of a case. For businesses, the problem is that the growing array of prescriptive transfer pricing rules results in an onerous compliance burden, which is particularly frustrating within the single market.

50. Tax administrations should consider if it is really practical and useful to mandate a specific list of documentation requirements for every transaction. To do so might even contravene the spirit of the OECD Guidelines, which state in paragraph 5.16: “The information relevant to an individual transfer pricing enquiry depends on the facts and circumstances of the case.”

51. A less prescriptive approach taken by tax administrations gives the taxpayer more flexibility and avoids the preparation and collection of data that is not relevant for the situation of the specific taxpayer. 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 in their particular business. A prescriptive approach, on the other hand, appears to offer greater clarity and certainty for both taxpayers and tax administrations but at a significant cost to smaller companies or those with relatively straightforward transfer pricing issues, as a great deal of irrelevant data may be prepared and collected.

52. Each of the documentation concepts as presented in Chapter D below has its own merits as regards flexibility and pragmatism on one hand, and certainty and reduced compliance costs on the other hand. It is obvious that there is some tension between these two opposing main objectives, and some Member States prefer to be more flexible whereas others tend to be more rigid.

53. The OECD Guidelines discuss (in a way that is intended to be illustrative; that is to say it is neither compulsory nor exhaustive) what documentation might be expected. On that basis, the information that might be expected to be found in documentation includes, in relation to any enterprise for a particular period:

a) the identification of cross-border transactions in that period with associated enterprises;

b) a description of the business in which the transactions occurred and the property (tangible and intangible) involved;

c) the scale of those transactions in that period and in immediately preceding periods;

d) the identification of the associated enterprises involved;

e) a description of the ownership linkages in that period between the enterprise and the relevant associated enterprises;

f) a description of the commercial relationship between the relevant enterprises (a functional analysis) and, in particular, the risk assumed by each party;

g) the terms of the contractual or other understanding between the relevant enterprises concerning the transactions or the business in which they were incurred.

54. In relation to controlled transactions the documentation should include:

a) an explanation of the taxpayer's transfer pricing policy

b) an explanation of the transfer pricing method used to establish the arm's length price;

c) why that method was selected, and

d) how that method has been applied;

e) a risk assessment questionnaire;

f) a comparability analysis, i.e.

i. characteristics of property and services;

ii. functional and risk analysis;

iii. contractual terms;

iv. economic circumstances; and

v. business strategies.

55. The relevance of each factor is dependant of the facts and circumstances of the case. A taxpayer may, therefore, reasonably be expected to prepare specific, more detailed documentation for extraordinary transactions, e.g. the transfer of intangibles or a substantive change of the functions and risks of the company. An enterprise should, however, not be required to justify why it has rejected those transfer pricing methods that it has not selected (in contrast to US requirements the OECD Guidelines do not

call for the company to prepare a comparison between prices prepared under different methodologies).

56. It would be useful for the enterprise to explain furthermore:

a) its general commercial and management strategy, or that of the group of which it is a member;

b) the current and forecast business and technological environment;

c) competitive conditions; and

d) regulatory framework.

3. Burden of Proof

57. Differences in Member States' rules on documentation requirements may in part be explained by differences in the burden of proof. Where the taxpayer bears the burden of proof, it is relatively easy for the tax administration to keep transfer pricing documentation rules short and simple.

58. In most Member States the burden of proof is on the tax administration, even though in most of these countries the burden of proof is shifted to the taxpayer if he does not fulfil his documentation requirements, e.g. where information is missing that only the taxpayer can provide.

59. In any case, as the OECD Guidelines state, "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".

C. THE USE OF DATABASE SEARCHES FOR COMPARABLES

I. General

60. To support the arm's length nature of intra-group transactions by using comparables, both the taxpayer and the tax administration have various possibilities for obtaining evidence ranging from the preferred source of information readily available within the company or group (internal CUPs) to external comparables searches based on databases.

61. According to the OECD Guidelines, a comparability analysis does not necessarily and in fact not primarily rely on a search for external comparables. Internal comparables, where they exist, should generally be preferred.

62. Practice shows that, taxpayers and tax authorities often have to rely on external comparables searches, either as a primary (in absence of internal comparables) or as a secondary (test) method of evidence. In those cases, the search for comparable transactions is normally performed on the basis of databases containing financial and economic information of companies.

63. Where a database is used it is not sufficient to use it alone, but the (often mainly quantitative) data collected from the database should be completed with (qualitative) information obtained from other sources such as industry surveys, market surveys, reports from financial analysts, companies websites, etc . Databases do not exist in all countries and the access to these databases is in most cases not free of charge. Also, appropriate processing of the information contained in these databases requires often substantive time and resources before an acceptable output is obtained.

64. The aforementioned database comparable searches are in general of particular relevance when using certain traditional methods or the transactional net margin method (TNMM) described in Chapter III of the OECD Guidelines. The OECD is currently discussing what the appropriate acceptable comparability standard for TNMM might be.

65. It should however be noted that transactional profit methods that are based on the profits from particular transactions between associated enterprises, may only be used when traditional transaction methods cannot be reliably applied alone or exceptionally cannot be applied at all. Profit methods should therefore be considered as methods of last resort and their use should be limited to the cases and methods described in the OECD Guidelines.

II. The availibility of appropriate database information

66. Both business and national tax authorities acknowledge that considering the differences in the nature and type of the available information following different domestic disclosure and reporting requirements, it is in some cases difficult to obtain adequate data on third party transactions which fully meet the five OECD comparability factors.

67. Differences in the detail of the available information and the lack of global accounting standards only aggravate this problem.

68. Some databases collect their information from publicly available data (e.g. public services or national banks), others collect data from private sector sources (e.g. major credit insurance institutions) or mix several sources.

69. Country specific databases might contain more detailed data but might also be more limited in the number of companies covered, depending on the information source.

70. Pan-European databases, are not a simple aggregate of country specific databases, might perhaps be less detailed since they need to align the differences in available country specific information to come to one comprehensive system, but relying on different information sources, could cover more companies which increases the possibility to find comparables.

71. Moreover, the growing level of globalization and economic integration leads to less uncontrolled transactions. Fewer and fewer independent companies facing economic and business conditions and with a functional profile similar to the entity of a MNE trying to comply with the arm's length principle can be found.

72. The existence of these different types of database initiates two different issues:

(i) the use of country specific comparables originating from pan-European databases in order to reduce subscription costs to a multitude of local databases; and

(ii) the use of comparables of other Member States originating from pan-European databases.

III. State of play in EU Member States

73. In a large majority of the Member States a local (or other) comparable search is not a statutory requirement. Most of the tax authorities however consider a comparable search as a highly recommended tool.

74. If applied, preference is given to local searches but in general, regional or pan-European searches are accepted in so far they respect the comparability factors and/or the results do not show any significant differences from the rest of a set of comparables

75. Although some Member States take the position that the differences between local and regional or pan-European searches are limited, the preference to use the former is being advocated on the basis of regional differences in profit level indicators (PLIs), industry specific differences in PLI or differences in accounting standards.

IV. The business point of view [1, 2]

1. General position

76. The business position is clearly that in cases where traditional methods cannot be applied and, therefore, the TNMM method needs to be used, non-domestic comparability searches should be accepted by national tax authorities as documentation to support the arm's length nature of a particular intra-group transaction. This position is mainly based on two fundamental arguments, one examining economic circumstances across the EU as one of the five comparability factors, another one taking into account compliance costs for businesses.

2. The existence of a genuine European single market

77. The results of a statistical analysis under the TNMM approach, performing (i) detailed comparability tests to develop pan-European and country specific arm's length ranges based on common OECD transfer pricing comparability practice and (ii) tests principally based on industry classification codes, covering 9 industries in 15 EU countries, clearly show that under both types of tests, European arm’s length ranges do not statistically differ from country-specific arm’s length ranges in almost all cases. Specifically, out of 234 tests conducted testing the statistical equality of upper and lower quartiles of arm’s length ranges using 95 percent confidence

[1] Contribution by Dr. Heinz-Klaus Kroppen: "Deloitte & Touche White Paper: Is Europe One Market? A Transfer Pricing Economic Analysis of Pan-European Comparables Sets"

[2] Contribution by Prof. Dirk Van Stappen:"Pan-European versus country-specific searches and Pan-European versus country-specific databases: not a clear-cut issue"

intervals, 219 tests (approximately 94 percent of the tests) generate results supporting the equality of inter-quartile ranges. In other words, it is highly likely that a country-specific comparability analysis and a pan-European comparability analysis would result in inter-quartile arm's length ranges of results that were not statistically different at a 95 percent level of confidence.

78. The analysis further gave evidence that when the country-specific arm's length range was statistically different from the pan-European arm's length range, there was no obvious bias or pattern of profit levels to indicate that a particular European country's arm's length range of results is always statistically different from the rest of Europe (differences arose from a particular transactions and not from particular country).

3. Keeping the compliance costs at an acceptable level

79. Notwithstanding that business might understand the reasons why national tax administrations prefer comparable information from their own local databases and markets, they argument that compliance costs for business should be kept at an acceptable level. In cases where pan-European database searches for a multinational enterprise are not accepted, the initial (or additional) search for comparables in several local databases results in any event in additional costs and additional sophistication. The access to databases is not free of charge and companies operating at global level can hardly be expected to pay for access to a multitude of local databases.

80. Moreover, a more sophisticated and costly search may not be warranted when estimating an arm's length range, i.e. finding an approximation and not an exact number). Indeed in many cases, a local comparables search is not really necessary since the resale price method, cost plus method and TNMM approach yield only approximate results in any event and since, certainly in case of a TNMM approach, there is, as demonstrated under a) consistency of ranges between a country-specific and a European search.

V. Conclusion

81. To determine the arm's length nature of a particular intra-group transaction and to be in line with the OECD Guidelines, preference should be given to the traditional transaction methods and taxpayers should demonstrate that a reasonable effort has been made to use these methods.

82. Practical difficulties in applying these methods may require some flexibility leading to the use of transactional profit methods and in particular TNMM without however affecting the aforementioned order of methodology advocated by the OECD.

83. In using certain traditional methods or the TNMM methodology, database searches for comparables play an important role to approximate arm's length conditions.

84. As a consequence of the further globalisation and integration of the economy and the deepening of the internal market, it should also be considered that a country-specific

search for comparables does not always generate an output that complies with all comparability factors.

85. Statistical analysis shows that for the use of the TNMM pan-European or non-domestic comparability analyses may produce reliable arm's length ranges of results similar to country specific arm's length ranges, although they may not be appropriate in all cases.

86. Although database searches do have some weaknesses, when handled with the necessary precautions, they seem in many cases both for taxpayers and tax authorities the most effective mechanism to produce benchmarking data.

87. The JTPF recognises that the use of the TNMM remains a method of last resort, but considers that database comparability searches are, when using this method or certain traditional OECD methods, often in practice an important tool to assess the arm's length nature of intra-group transactions.

88. The JTPF therefore recommends tax administrations not to reject automatically domestic or non-domestic comparables found in pan-European databases but to evaluate them with respect to the specific facts and circumstances of the case.

89. Not impeding the right of a tax administration to make an adjustment if it judges that the arm's length principle has not been met, national tax authorities are further recommended that, where a taxpayer has demonstrated that he has made reasonable efforts to first use the traditional transaction methods recommended by the OECD and has soundly documented his comparability searches and especially their compliance with the five OECD comparability factors, the use of non-domestic comparables by itself should not subject the taxpayer to penalties for non-compliance.

D. POSSIBLE CONCEPTS OF EU-WIDE DOCUMENTATION

I. Best Practice

90. Under the best practice method different countries' legislation, administrative rules and practices on documentation requirements would be examined. The Forum would then seek to identify - on the basis of consensus - the most suitable features and recommend Member States to align themselves to these rules and practices.

91. A best practice approach is the least prescriptive common approach to avoid the fragmentation of documentation rules in Member States. It would avoid the problems associated with standardisation, e.g. reaching agreement on a uniform set of documentation and revising it simultaneously in 15 (or even 25) Member States. Also, taxpayers could be more flexible in the way they prepare their documentation. On the other hand, under the best practice approach taxpayers would still be obliged to prepare a large number of separate and unique documentation packages. It would also provide taxpayers with less certainty as to what documents the tax administrations might require.

92. For tax administrations, the main benefit of a common approach, such as the best practice, would be a co-ordination of documentation requirements and thus a level

playing field. Tax administrations would be less concerned that taxpayers might be inclined to shift income to those countries where the strictest documentation requirements are in place.

II. Standardised Documentation

93. The goal of a uniform, EU-wide set of rules for documentation requirements, according to which all enterprises in Member States continue to prepare separate and unique documentation packages but in accordance with one set of rules, are transparency and more certainty in the context of transfer pricing examination. This more prescriptive approach aims at arriving at a decentralised but standardised set of documentation.

94. The main advantage for taxpayers is less compliance costs in preparing transfer pricing documentation, because they would have to deal with only one set or rules, more certainty as to what level of documents tax administrations might expect and protection against penalties. However, this leaves less flexibility for taxpayers to make reasonable decisions on what is relevant under the facts and circumstances that prevail.

95. For tax administrations, the main benefit of standardised documentation would be similar to the best practice approach. As the level of co-ordination would be even higher, differences in documentation requirements could no longer be an incentive for taxpayers to shift income.

96. In addition, standardised documentation might make MAPs easier as all documentations in the Member States concerned would be in accordance with the same set of rules.

[*Please note: the following chapter has been amended in light of the fact that the masterfile concept has been changed and is now distinct from the centralised documentation. The masterfile concept itself will be presented as a separate approach in chapter V.***]**

III. Centralised (integrated global) Documentation

97. The centralised (or integrated) documentation concept goes one step further than the standardised documentation. In an EU-wide centralised approach a multinational group would prepare a single set of documentation that could serve as the basis for preparing specific local country documentation from both local and central sources. This centralised documentation would provide a "blue print" of the company and its transfer pricing system that would be relevant for all Member States concerned. The centralised documentation concept would not aim to shift the obligation to provide transfer pricing documentation from the enterprise to a foreign tax administration. This obligation would remain with the taxpayer.

98. The framework of such a centralised documentation should consist of the following items:

    a) description of the business;

    a) the group's organisational, legal and operational structure;

b) identification of the associated enterprises engaged in controlled transactions;

c) description of the controlled transactions;

e) comparability analysis, i.e.

i) characteristics of property and services;

ii) functional and risk analysis;

iii) contractual terms;

iv) economic circumstances; and

v) business strategies;

f) ownership of intangibles;

g) substantiation of the arm's length nature of the company's transfer pricing, e.g. by providing inter-company transfer pricing instructions;

h) explanation about the selection and application of the transfer pricing method;

i) an undertaking by the taxpayer to provide supplementary information upon request; and

k) Cost Contribution Agreements, APAs and Rulings.

This framework should be filled in with the facts and circumstances of the specific situation, taking into account the complexity of the enterprise and the transactions.

99. The contents of the centralised documentation should be consistent in all EU Member States. **[**It could be expected that the centralised documentation would be prepared in the language of the country where the headquarter is located or in a language that is commonly understood in most other countries. Upon request of a tax administration the taxpayer would, however, be required to provide a translation in the official language of that tax administration.**]**

100. A centralised documentation would substantially reduce taxpayers' compliance costs thus reducing the burden of intra-community trade. It would also help taxpayers comply because it would both facilitate the documentation process and the central administration of transfer pricing policies.

101. A centralised approach would not be contrary to the interests of a tax administration. From the steps often followed by multinational enterprises engaged in this process, it is likely that documentation would 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. Given that the objective of a tax administration is information, a centralised approach would rather be to its advantage, because one of the main benefits of the centralised approach would be an improvement in the quality of the documentation. This would help safeguard a tax administration's tax base.

102. The concept of a centralised documentation would not affect a taxpayer's obligation to submit information to the tax administration of the country of which it is an enterprise or permanent establishment and it should be noted that a centralised documentation would not necessarily satisfy the documentation requirements in each Member State. Tax administrations would, therefore, be entitled to request from a

taxpayer additional country- or transaction-specific information that is not included in thecentralised documentation.

103. A centralised documentation may, however, pose more problems than a decentralised approach as regards the scope of application. For example, in a centralised approach it must be decided whether or not non-EU subsidiaries of an EU parent company should be included in the centralised EU documentation. The consequences of a centralised approach on EU enterprises with non-EU shareholders also need to be examined. It would be difficult to oblige a non-EU company to comply with EU documentation rules. This would not preclude multinational enterprises preparing a centralised documentation package on a voluntary basis. A centralised approach, therefore, might call for a more global solution within the framework of the OECD.]

IV. Summary of Pros and Cons of the Three Different Concepts

104. Each of the three documentation concepts has specific features and has its own pros and cons. A centralised documentation, for example, seems not to be appropriate in all cases. As a centralised documentation by definition implies that the documentation is prepared by the parent company or headquarters of a group of companies it requires the uniform identification of the parent company or headquarters by the group itself and all tax administrations involved before the documentation is prepared. It follows that the use of a centralised documentation depends on the group structure and is not appropriate for decentralised companies.

105. Business and administrations may also have different perspectives on the pros and cons of the various documentation concepts. The pros and cons of the different concepts are summarised in a quantitative manner in the grid on the next page.

DOCUMENTATION CONCEPT	**PROS**	**CONS**
Code of Best Practice (descriptive, modifications possible)	For taxpayers • flexibility • avoids problems associated with standardisation, e.g. reaching agreement on a uniform set of documentation and revising it simultaneously in MS For tax administrations • flexibility	For taxpayers • may be too vague • still required to prepare a large number of separate and unique documentation sets (possibly in 25 MS) • little certainty, because maybe too vague and application may vary from country to country For tax administrations • may be too vague • level playing field only insofar as MS adopt best practice rules
Standardised Documentation (prescriptive, no modifications possible)	For taxpayers • reduction of compliance costs • certainty with respect to documentation requirements • reduced number of double taxation cases due to common approach in MS	For taxpayers • less flexibility to decide what documents may be relevant

	For tax administrations • more transparency • level playing field among MS • avoids profit shifting due to differences in documentation requirements in MS • in combination with uniform penalty rules for non-compliance in MS: even less incentive for profit shifting • reduced number of double taxation cases due to common approach in MS • facilitates MAPs	For tax administrations • less flexibility, i.e. requires agreement on common set of documentation • simultaneous revision in all MS necessary
Standardised and Centralised Documentation / (in addition to standardised documentation) (prescriptive, no modifications possible)	For taxpayers • higher degree of certainty • lowest compliance costs • useful for risk assessment purposes For tax administrations • better quality of taxpayers' documentation • enhanced taxpayers' compliance • useful for risk assessment purposes • more transparency	For taxpayers • not suitable for decentralised group structures • difficulty in some instances to identify parent company / headquarters For tax administrations • common definition of „associated / affiliated enterprise" and „headquarters" necessary • coverage of standardised and centralised documentation needs to be agreed upon • access to documentation abroad more difficult • for non-EU group members: relation to documentation requirements in non-EU countries needs to be clarified

[*Please note: the following chapter V is the unmarked version of document JTPF/003/REV3/2004/EN*]

V. The Masterfile Concept – A New Approach

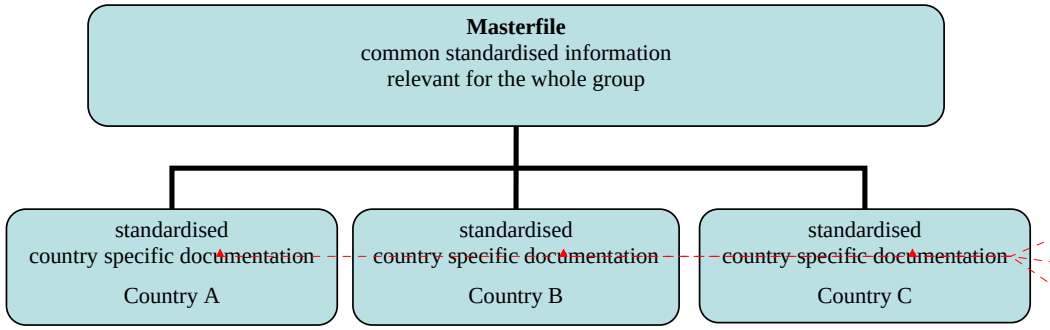
1. Description of the concept

1.1. General approach

106. The "masterfile" concept is an enhanced version of the centralised, standardised documentation concept. In an EU-wide context a multinational group would prepare **one set of standardised EU Transfer Pricing Documentation** ("EU TP Documentation") that would consist of two main parts (i) one uniform set of documentation containing common standardised information relevant for all EU group members (the "masterfile") and (ii) several sets of standardised documentation each containing country-specific information ("country specific documentation"). The masterfile concept means, therefore, that a multinational group of companies has a standardised set of documentation (the "masterfile" supplemented by "country specific documentation") at company level for all associated enterprises in all countries as opposed to standardisation of documentation at country level for all

companies in that country regardless of the industry sector or group to which they belong.

The masterfile concept can best be illustrated with the following chart:



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The documentation set for country A would consist of the common masterfile supplemented by the standardised country specific documentation for country A; the documentation set for country B would consist of the same common masterfile supplemented by the standardised country specific documentation for country B.

1.2. Purpose of a masterfile

107. The masterfile would serve both as a basic set of information for the assessment of the group's transfer prices and as a risk assessment tool (i) for taxpayers to identify transactions that may require more detailed explanations and documentation and (ii) for tax administrations for case selection purposes and as a starting point for the examination of the company's transfer pricing. The masterfile concept would improve the quality of the documentation and enhance taxpayers' compliance with transfer pricing documentation requirements in EU Member States. It would thus reduce the risk of double taxation and the exposure to documentation related penalties.

1.3. Advantages of a masterfile

1.3.1. For both taxpayers and tax administrations

108. One of the main benefits of a masterfile is the fact that all tax administrations involved would have access to the same common documentation and information as far as they are relevant for the Member States concerned. Taxpayers and tax administrations alike would benefit from the following advantages of a masterfile:

a) Possibility to prepare more detailed material on the group as a whole, analysing group accounts, accumulating inter-company contracts, etc.;

b) More consistency in the functional analyses;

c) More consistency in the application of transfer pricing methods;

d) Enhanced transparency of the transfer pricing process;

e) Leverage from experience and prior work wherever possible;

f) Centralisation of the review of any material prepared at local level to avoid misunderstandings;

g) Facilitation of compliance; and

h) Reduction, facilitation and expedition of mutual agreement procedures.

1.3.2. From a taxpayer perspective

109. Standardised and centralised documentation would substantially reduce a taxpayer's compliance costs by fulfilling the documentation requirements in all EU Member States in a similar and efficient way (economies of scale). At the same time, by complying with the standardised EU TP Documentation in all EU Member States, taxpayers would benefit by avoiding to be subjected to documentation related penalties.

110. A taxpayer acting in good faith and providing in a timely manner appropriate documentation as described in chapter 3.2 and 3.3 below and implementing it, i.e. properly applying its documentation to determine its arm's length transfer prices, should not be subjected to documentation related penalties or denied access to the EU Arbitration Convention.

111. Additional benefits for taxpayers are:

a) reduced probability of being audited; and

b) reduced risk of double taxation.

1.3.3. From a tax administration perspective

112. From the steps often followed by multinational enterprises engaged in this process, it is likely that documentation based on the masterfile concept would be prepared by individuals with more experience of transfer pricing and with more information to hand than would be the case if documentation were prepared at a decentralised country level. Given that the objective of a tax administration is information, a centralised and thus consistent approach would be to its advantage, because one of the main benefits of a consistent approach would be an improvement in the quality of the documentation. This would help safeguard a tax administration’s tax base.

113. The Member States concerned would benefit substantially because they would have insight in the EU-wide transfer pricing policy of the company. The contents of the EU TP Documentation as specified in chapter 3.2 and 3.3 below would allow Member States to:

a) have more information about intra-group transactions that are relevant for the Member States concerned;

b) more effectively perform their risk assessment;

c) reduce administrative costs; and

d) assess the transfer prices of the inter-company transactions.

2. The basic functioning of the masterfile concept

2.1. General acceptance by tax authorities mandatory

114. A necessary feature of the masterfile concept is a standardisation of the type of information and documents required by Member States' tax administrations. Obviously, a Member State may decide not to have transfer pricing documentation at all or have a shorter version of theEU TP Documentation, i.e. require less items in the masterfile or the country specific documentation. However, a Member State that adds items to the masterfile or the country specific documentation would depart from the masterfile concept.In order for taxpayers to fully benefit from the advantages of the masterfile concept, i.e. notably the reduction of compliance costs and the avoidance of documentation related penalties, all Member States should accept it.

2.2. Mandatory vs. optional application for taxpayers

115. Whereas for centralised MNEs the masterfile concept may reduce the compliance burden and has a potential to increase the quality of its documentation, this is not necessarily the case for decentralised MNEs, smaller businesses or groups of companies with limited cross-border dealings. Considering the fact that creating and maintaining a masterfile might entail costs that are not always compensated for by economies of scale, certain businesses might prefer a decentralised approach. The use of the masterfile concept should therefore be optional for businesses. A company should, however, not arbitrarily opt in and out of the masterfile concept for its documentation purposes but retain a certain degree of consistency and continuity in its documentation policy. Also, a multinational group of companies should apply the masterfile concept collectively to all group members within the EU.

2.3. Rights and obligations of taxpayers and tax administrations

116. The masterfile concept would not aim to shift the obligation to provide transfer pricing documentation from the domestic enterprise to a foreign jurisdiction. This obligation would remain with the domestic taxpayer who in any event is responsible under domestic law for complying with documentation requirements although it might not be the physical owner of the masterfile (see also paragraph 38 below).

117. Each of the tax authorities involved would also keep the right to assess whether in the context of the agreed masterfile concept, the company has met its documentation requirements.

2.4. Implementing the Masterfile Concept

118. There are two ways in which a Member State could adopt the masterfile concept:

a) by legislating for it in national law (which would provide the greatest certainty); or

b) if such an approach were possible under national law, by including it in administrative guidelines on which businesses would be entitled to rely.

In both cases adoption of the masterfile concept by a Member State would confer a legally enforceable right to the taxpayer to be exempt from documentation related penalties if the documentation requirements as specified in chapter 3.2 and 3.3. below were met (see Annex II "Draft Recommendation from the Council to the Member States").

2.5. Consequences for Member States not having legal documentation requirements

119. In relation to documentation requirements, one of the main concerns expressed by the business community is that the mere existence of different sets of documentation requirements and its potential to expand to over 25, represents an additional burden for a company in one Member State to set up and/or conduct business with an affiliated company in another Member State.

120. Currently not all EU Member States have legislation on documentation requirements in place. If, which is of course not unlikely, in the future more countries will introduce national documentation requirements, these should be compatible with the masterfile concept.

2.6. Consequences for Member States who already have legal documentation requirements

121. As the masterfile concept is a standardised approach, it follows that the type of transfer pricing documentation should be the same for all countries that decide that transfer pricing documentation is required. An aggregation of all existing documentation requirements of all Member States would, however, not be appropriate. Although the benefit of a consistent approach would still be achieved, Member States should not follow the "race to the top" and increase documentation requirements to the currently most extensive ones.

122. The contents of the masterfile and the country specific documentation should, therefore, be as complete as necessary but as limited as possible to serve its purpose as described in chapter 1.2 above (the contents of both is addressed in more detail in chapter 3 below). Member States should, however, retain the right to require a taxpayer to provide further information upon specific request or during a tax audit.

123. A Member State who requires taxpayers in accordance with domestic documentation rules to prepare additional documentation to what is already available in the masterfile or the country specific documentation as specified in chapter 3.2 and 3.3 below, would deviate from the masterfile concept. It should be noted that such additional documentation requirements might not only be incompatible with the main purposes of the masterfile concept, i.e. to relieve taxpayers' compliance burden and safeguard from documentation related penalties, but might also distort the level playing field among Member States.

124. Penalties for failing to comply with transfer pricing documentation rules are imposed under national law. Any guarantee that penalties would not be imposed if certain conditions were met would also need to be delivered through national law. In adopting such law, a Member State should only be concerned with whether the conditions had been met in relation to transactions within the scope of its national tax law. On that basis, a Member State would not be concerned with whether the group involved had satisfied any particular quality of documentation in respect of transactions that might be within the scope of the tax laws of other Member States but were not within the scope of its own tax laws.

125. A Member State should, therefore, not impose any penalty on a business for failing to make transfer pricing documentation available to its tax administration if the business, or another business with which it was associated (whether or not that other business was resident in the Member State) :

a) had documentation available as specified in chapter 3.2 and 3.3 below;

b) that documentation was made available to the tax administration within a reasonable time after the tax administration had made a reasonable request; and

c) that documentation was made available in a reasonable manner.

3. Contents of the EU TP Documentation

3.1. In general

126. The content of the master file and the country specific documentation is generally understood to be a roadmap (or standardized document) of a multinational group's intercompany relations and transactions. It should contain enough details to allow the tax administration to make a risk assessment for case selection purposes or at the beginning of a tax audit and ask relevant and precise questions regarding the company's transfer pricing.

127. Each of the following items of the EU TP Documentation, i.e. the masterfile supplemented by the country specific documentation, should be completed, taking into account the complexity of the company and the transactions. It is recommended that information is used that is already in existence within the group (for management purposes). However, a company might be required to produce documentation for this purpose that otherwise would not have been in existence.

3.2. The masterfile

128. The “masterfile” should follow the economic reality of the enterprise and provide a “blue print” of the company and its transfer pricing system that would be relevant for all Member States concerned.

129. The masterfile should contain the following items:

a) description of the business and business strategy including changes in the business strategy compared to previous tax years;

b) the group’s organisational, legal and operational structure where relevant for EU Member States (including an organisation chart, a list of group members and a description of the participation of the parent company in the subsidiaries);

c) identification of the associated enterprises engaged in controlled transactions with and within the EU;

d) general description of the controlled transactions with and within the EU, i.e.

   i) flows of transactions (tangibles, intangibles, services);

   ii) invoice flows;

   iii) values of transaction flows;

e) general description of functions performed and risks assumed including description of changes in respect of functions and risks compared to previous tax years, e.g. the change from a full fledged distributor to a commissionaire;

f) ownership of intangibles (patents, trademarks, brand names, know how etc.) and royalties paid or received;

g) substantiation of the arm's length nature of the company's transfer pricing, e.g. by providing the group's inter-company transfer pricing instructions or a description of the group's transfer pricing system;

h) an undertaking by the taxpayer to provide within a reasonable time frame according to national rules supplementary information upon request; and

i) Cost Contribution Agreements, APAs and Rulings as far as group members in the EU are affected.

130. The possible scope of the enterprises and transactions to be included in the masterfile can best be described with the following example:

Consider a headquarter company A in Member State A providing HQ services to subsidiary B (a production company) in Member State B and subsidiary C (a distribution company) in Non-Member State C (controlled transactions 1 and 2, cost plus method applied). Subsidiary B delivers goods to its sister company C (controlled transaction 3, resale price method applied). In order to allow the tax administrations in Member States A and B to obtain information on the transactions between A and B and between B and C (controlled transactions 1 and 3) the masterfile has to contain information concerning controlled transactions 1 and 3 in all three States. This means, for example, that Member State A may also obtain information regarding controlled transaction 3 (between Member State B and Non-Member State C).

3.3. Country specific documentation

131. The content of a country specific documentation is a supplement to the masterfile. Both together constitute the documentation file for the respective EU Member State. In order to meet the EU TP documentation requirements, a country specific

documentation should contain, in addition to the content of the masterfile, the following items:

a) details of country specific controlled transactions;

b) comparability analyses, i.e.

   i) characteristics of property and services;

   ii) detailed functional and risk analyses;

   iii) contractual terms;

   iv) economic circumstances;

   v) specific business strategies; and

   vi) benchmark studies if available; and

c) an explanation about the selection and application of the transfer pricing method, i.e. why a specific transfer pricing method was selected and how it was applied.

132. As the organisational and operational structures of MNEs vary widely, a multinational group should be free to shift items from the country specific documentation to the masterfile. This should allow taxpayers sufficient flexibility to accommodate for specific circumstances. The following two examples illustrate the flexibility:

Example 1:

Masterfile

a) description of the business
b) the group's organisational, legal and operational structure
c) identification of the associated enterprises engaged in controlled transactions
d) general description of the controlled transactions
e) general description of functions and risks
f) ownership of intangibles
g) substantiation of the arm's length nature of the company's transfer pricing
h) an undertaking by the taxpayer to provide supplementary information upon request
i) Cost Contribution Agreements, APAs and Rulings

minimum requirement

Standardised country specific documentation

a) details of country specific controlled transactions
b) comparability analyses
c) explanation about the selection and application of the transfer pricing method

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Example 2:

Masterfile

a) description of the business
b) the group's organisational, legal and operational structure
c) identification of the associated enterprises engaged in controlled transactions
d) general description of the controlled transactions
e) general description of functions and risks
f) ownership of intangibles
g) substantiation of the arm's length nature of the company's transfer pricing
h) an undertaking by the taxpayer to provide supplementary information upon request
i) Cost Contribution Agreements and APAs and Rulings
j) comparability analyses
k) explanation about the selection and application of the transfer pricing method

minimum requirement

Standardised country specific documentation

a) details of country specific controlled transactions

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133. Any country specific information and documents that relate to a controlled transaction involving one or more Member States must be contained either in the country specific documentation of all the Member States concerned or in the common masterfile.

Example:

The Swiss subsidiary of a French parent company provides R&D services to its Austrian sister company. In relation to the Swiss subsidiary the masterfile of the group must contain the items a) – i) as described in paras. 24 and 25 above. In addition, the country specific documentation for the Austrian subsidiary must also contain country specific information and documents in relation to the Swiss subsidiary, i.e. the items a) – c) as described in para. 26 above, unless these information and documents are contained in the masterfile.

4. Use of language

134. Serving the purpose of the masterfile concept, i.e. the reduction of the compliance burden, only a limited number of documents should be available in the relevant national languages from the outset and translation of all documents should be made available only upon request during a tax audit

5. Preparation, submission and storage of the documentation

135. The evidence required for preparing the masterfile and country specific documentation can reasonably be expected to be available to the company at the time of the transaction. However, the taxpayer should have to submit its documentation, i.e. the masterfile and the country specific documentation, to the tax administration only at the beginning of a tax audit or upon specific request. By contrast, when filing the tax return, a taxpayer may only be required to submit a questionnaire or risk assessment form of no more than two or three pages. An example of such a questionnaire can be found in annex I of this paper [*document Denmark_Annex_I*].

136. A Member State could, however, have rules to require a business to make available documentation in response to a specific request made by the tax administration or at the start of a tax audit. Even if the Member State had adopted the masterfile concept, the scope of such additional documentation might go beyond what was required by theEU TP Documentation.

137. The Member State might have rules imposing a penalty for failing to make such additional documentation available. But, if it had adopted the masterfile concept, the Member State could not have rules imposing a penalty for failing to make available such additional documentation at the time the masterfile and the country specific documentation was due to have been made. Any such rules imposing a penalty could only apply to a failure to make documentation available in response to an appropriate request made by the tax administration after the masterfile and the country specific documentation was due to have been made.

138. The rules should allow the business a reasonable amount of time to make the additional documentation available. Since the documentation would not need to exist at the time the tax return was due to be made, and might never exist at all if the tax administration did not request it, this period should be longer than the period that the business would need to make available documentation covered by the masterfile and the country specific documentation. It might be appropriate to specify that the Member State should not apply such penalties by reference to a time less than 60 days after an appropriate request has been made by the tax administration.

139. Generally speaking, it should be irrelevant for tax administrations where a taxpayer prepares and stores its documentation as long as the documentation is sufficient and made available to the tax administrations involved upon request.. The taxpayer should, therefore, be free to keep the masterfile either in a centralized or in a decentralized manner.

140. Taking into account the basic principles of the masterfile concept, it can be expected that the parent company undertakes to prepare timely the masterfile in order to comply with any reasonable request originating from one of the tax administrations

involved. The taxpayer in a given Member State should make the masterfile and the country specific documentation available upon request of a tax administration, within 30 days from the date of the request.

141. The way that documentation should be stored - whether on paper, in electronic form or in any other system - should be at the discretion of the business, provided that it could be made available to the tax administration in a reasonable way.

142. The enterprise should not be obliged to retain documentation beyond a reasonable period consistent with the requirements of domestic law both at parent company and group entity level.

143. The business that would be responsible for making documentation available to the tax administration would be the business that was requested to make the tax return and that would be liable to a penalty if adequate documentation were not made available. This would be the case even if the documentation was prepared and stored by one company within a group on behalf of another.

144. If a Member State adopted the masterfile concept, a corporate group would need to keep documentation as specified in the masterfile concept in respect of all its members, including permanent establishments, in that Member State if it wanted to enjoy the freedom from penalties in respect of any particular member company or permanent establishment.

145. A parent company or headquarter has access to all information and documents concerning its subsidiaries. A subsidiary, on the other hand, must have access to all information and documents concerning its transactions with related parties. Information and documents, however, that do not relate to a subsidiary's own transactions do not have to be contained in the masterfile or in the subsidiary's country specific documentation. A tax administration should, therefore, not impose the obligation on a subsidiary to supply such information or documents. Rather, such information or documents can be obtained by making a request for information to the other tax adminstration involved under the exchange of information article of the bilateral double tax treaty or the Council Directive 77/799/EEC concerning mutual assistance by the competent authorities of the Member States in the field of direct taxation, certain excise duties and taxation of insurance premiums, as amended by Council Directive 2004/56/EC of 21 April 2004 (Mutual Assistance Directive).

6. Scope of application of the masterfile concept

146. For the masterfile concept to be applied consistently within the EU, the following question needs to be addressed:

Which legal entities should be considered to be included in the group structure, i.e. need to be considered as "associated enterprises" for including documentation on the intra-group transactions in the masterfile?

147. Whereas Member States have adopted a variety of definitions of "associated enterprise" for various purposes, according to the OECD Guidelines, an associated enterprise is an enterprise that satisfies the conditions set forth in Article 9, sub-paragraphs 1*a)* and 1*b)* of the OECD Model Tax Convention. Under these

conditions, two enterprises are associated if one of the enterprises participates directly or indirectly in the management, control, or capital of the other or if "the same persons participate directly or indirectly in the management, control, or capital" of both enterprises, i.e. if both enterprises are under common control.

<u>Question:</u> Considering the aforementioned OECD definition of "associated enterprises" do Members agree to adopt this definition for the masterfile concept which would also include individual taxpayers?

E. PROPOSED RECOMMENDATIONS FOR DOCUMENTATION RULES

I. Timing - Preparation and Submission of Documentation

148. The evidence required for preparing transfer pricing documentation can reasonably be expected to be available to the enterprise at the time the transfer price is determined. This includes evidence that the enterprise can reasonably be expected to obtain from another party.

149. In order to be able to defend itself in the event of a transfer pricing examination an enterprise is well advised to use the information available at the time of determining its transfer price. On the other hand, a tax administration should not use hindsight, i.e. request evidence that would not reasonably have been available to the enterprise at the time of the determination. In both cases, the question of what is reasonable must necessarily be a matter of judgement. It is not possible to prescribe rules to say precisely what is and what is not reasonable.

150. Regarding when the documentation needs to be available, it is assumed that it is most efficient for the taxpayer if he prepares documentation at the time of the transaction. It is very risky to prepare documentation only on request. Information may no longer be available afterwards because employees dealing with the transactions are no longer available or associated companies have been sold. The time when documentation is prepared should, however, be left to the discretion of the taxpayer. It follows that the risk of non-compliance, including the risk of being exposed to penalties, is on the taxpayer.

151. Some Member States distinguish between ordinary and exceptional transactions. They take the view that taxpayers should be required to prepare documentation on exceptional transactions within a narrow time-frame. Transactions to be regarded as exceptional in this context are in particular transfers of assets in the course of restructuring, fundamental corporate changes in respect of functions and risks, transactions linked to changes in the business strategy, the sale of valuable intangible assets etc.

152. Documentation, which records the evidence, will not necessarily come into existence at the same time as the evidence. The OECD Guidelines say that tax administrations

should limit the amount of documentation that they require an enterprise to provide at the time it files a tax return.

153. Regardless of the time when the taxpayer prepares his documentation it should be available upon request of the tax administration. Taxpayers are, therefore, expected to submit documentation, having regard to the complexity of the transactions, within 30 to 90 days from the request.

154. The documentation recording the evidence necessary for a tax return should exist at the time when the return is made or, at the very least, should be capable of being produced reasonably soon after any enquiry is made by the tax administration. This does not, however, mean that enterprises are required to supply such documentation at the time the return is made. In order to calculate its taxable profit, the enterprise, however, needs to have the appropriate transfer pricing evidence, i.e. basic accounting information on the intra-group transactions, valuation of the transactions, the related parties involved, adjustments to the transfer prices made etc., available at that time. Otherwise the tax return could not be filed properly.

155. There seems to be common understanding between taxpayers and tax administrations that documentation made available during a tax audit needs to be more comprehensive and detailed than any information submitted when filing the tax return. For example, the taxpayer should not be required to submit documentation demonstrating to the tax administration that the arm's length principle has been met when filing the tax return but only in case of a tax examination.

II. Application of Documentation Rules

1. Aggregation of Transactions

156. The OECD Guidelines recommend in para. 1.42 that ideally, in order to arrive at the most precise approximation of fair market value, the arm's length principle should be applied on a transaction-by-transaction basis. They concede, however, that there are situations where a taxpayer's own transactions are so closely linked or continuous that they cannot be evaluated separately. They also state that in some circumstances it may be appropriate to determine the transfer pricing on a package basis. It should be noted, however, that paragraph 1.42 of the OECD Guidelines isnot concerned with the question of whether or not third party data aggregated on a company-wide basis could be used for practical reasons in a comparability analysis. This is a separate issue that is discussed by the OECD in the framework of the review of comparability in general.

157. Conversely, businesses maintain that the only practical way to manage transfer pricing in a major multinational enterprise is for aggregations of transactions to be made and for broad guidelines on the setting and maintenance of transfer prices to be followed. Arguably, this may also be the only practical basis on which to conduct tax audits of transfer pricing. Where appropriate, information about a taxpayer's transactions that are identical, or at least very similar, should, therefore, be allowed to be aggregated taking into account the number and complexity of the transactions. The aggregation rules must, however, be applied consistently and must be transparent to the tax administration.

2. Availability of Information

158. Not all information may be readily available to the taxpayer from local commercial and management records. Documentation that may not be readily available in that sense may include, inter alia:

- comparability, functional and risk analyses;
- substantiation of the selected transfer pricing method.

159. It should be undisputed that a parent company can request information from its foreign subsidiaries. An important issue for tax administrations, however, is the question of whether a company can be required to request relevant information and documentation from its foreign parent or affiliated company. In case the taxpayer claims to have no access to data abroad, e.g. secret commercial data, the question arises if the taxpayer should nevertheless be obliged to provide this information and if there should be sanctions in case of non-compliance.

160. A related issue is the definition of "relevant" information that a tax administration may request from a foreign parent or affiliated company. For example, if a tax auditor examines the subsidiary A in country A, can the auditor legitimately expect to receive information concerning transactions between its parent company B in country B and its affiliate C in country C in an effort to find comparables?

161. The way documentation is stored (for example, original documents or in a form involving some degree of processing) should be at the discretion of the enterprise.

3. The conduct of the Tax Administration

162. As far as the conduct of the tax administration is concerned, the tax administration should:

a) leave to the discretion of the enterprise the form in which documentation is stored (for example, whether it is in electronic or paper form) as long as it can be made reasonably accessible to the tax administration;

b) not require enterprises to retain documentation beyond a reasonable period consistent with the requirements of domestic law;

c) not impose an unreasonable cost or administrative burden on enterprises in requesting documentation to be created or obtained;

d) only request documentation that have a bearing on transactions under review; and

e) make every endeavour to ensure that there is no public disclosure of confidential information contained in documentation.

163. In order to alleviate taxpayers' compliance burden, the tax administration should also consider the following points:

a) where documentation produced for one period remains relevant for subsequent periods and continues to provide evidence about arm's length pricing, it may be appropriate for the documentation for subsequent periods to refer to earlier documentation rather than to repeat it;

b) documentation does not need to replicate the documentation that might be found in negotiations between enterprises acting at arm's length (for example in agreeing to a borrowing facility or a large contract) as long as it includes adequate information to assess whether an arm's length price has been applied; and

c) the sort of documentation that needs to be produced by an enterprise that is a subsidiary company in a group may be different from that needed to be produced by a parent company; i.e. a subsidiary company would not need to produce information about all of the cross-border relationships and transactions between associated enterprises within the group but only about those relationships and transactions relevant to the subsidiary in question.

4. Simplifications for Small and Medium-Sized Enterprises

164. A "reasonableness"-test could be applied in assessing the documentation standards appropriate for different types and sizes of business. As a matter of pragmatism, Member States should examine the scope for reduction of the documentation requirements for SME's and place – as far as possible – a lower compliance burden on SMEs as compared to subsidiaries of large multinational enterprises. This would not contravene the OECD Guidelines.

5. Language

165. The requirement contained in some Member States' documentation rules to provide documentation in the national language of that state can result in very time consuming and expensive translation demands. The issue of language is about to become even more important with the accession of new states.

166. Tax administrations can make reasonable requests for documents to be translated. They should, however, consider that it may not always be necessary for documents to be translated into a local language. Statutory requirements may demand it but local language skills may render it unnecessary. In order to minimise costs and delays caused by translation, tax administrations should accept documents in a foreign language as far as possible. Where this is not possible taxpayers could be given the possibility to provide a translator to give explanations.

6. Penalties

167. Discussion of transfer pricing documentation is very often linked with discussion about the imposition of penalties. The link is made very often in discussion of US regulations or the PATA agreement where the provision by an enterprise of good quality documentation is a means of ensuring that penalties will not be imposed. However, only few Member States have specific transfer pricing penalties.

168. A taxpayer who can show that an honest and reasonable attempt has been made to comply with the arm's length principle (demonstrating good faith), in particular by means of good quality documentation, should not be subjected to a transfer pricing penalty. In determining whether there has been negligent conduct, each case should be judged on its own facts and merits.

169. The keeping of detailed documentation will not, of itself, free a person from the possibility of a penalty if that documentation does not show that the person had good grounds for believing that the arrangements and prices were in accordance with the arm's length principle. Business, however claim, that a taxpayer who has complied with documentation requirements should not be subjected to penalties related to non-compliance with documentation requirements or denying him access to dispute resolution procedures.

170. However, the imposition of penalties in the course of tax administration is a matter going beyond just transfer pricing and depends primarily on domestic law.

7. Application to Permanent Establishments

171. The proposed recommendations on documentation requirements as described above should also apply to transactions involving a permanent establishment.

[Please note: The following Annex is a contribution from a Tax Administration Member]

ANNEX II

DRAFT RECOMMENDATION FROM THE COUNCIL TO THE MEMBER STATES

1. A Member State should not impose any transfer pricing penalty if, at the time the business was due to make its tax return, the business, or another business with which it was associated (whether or not that other business was resident in the Member State) :

   (a) had documentation available as specified in paragraph 2 below;

   (b) that documentation was made available to the tax administration within a reasonable time after the tax administration had made a reasonable request;

   (c) that documentation was made available in a reasonable manner.

2. A transfer pricing penalty specified in paragraph 1 above is

   (a) a penalty for failing to make documentation available;

   (b) a penalty for making a transfer pricing adjustment; or

   (c) a serios penalty for purposes of the Arbitration Convention

3. The documentation specified in paragraph 1 above consists of:

   (a) an identification of all the businesses with which the business in question had transactions to which transfer pricing rules applied during the period covered by the tax return;

   (b) an explanation of the ownership relationship (in terms of shareholding or other powers through which control can be exercised) between the businesses in question and the associated businesses specified in (a) above throughout the period covered by the tax return;

   (c) an explanation of any creditor/debtor relationship between the businesses in question and the associated businesses

specified in (a) above at any time in the period covered by the tax return;

(d) an identification of the transactions to which transfer pricing rules applied between the business in question and the businesses specified in (a) above during the period covered by the tax return;

(e) an explanation of the activities or relationship in respect of which the transactions specified in (d) above took place;

(f) an explanation of the role played by the business in question and the businesses specified in (a) above in the activities or relationship specified in (e) above and, in particular, an explanation of the risk borne by each party in terms of, for example, inventory and exchange rate fluctuations;

(g) an identification of the method used to establish an arm's length result for the transactions specified in (d) above and an explanation of why that method was the most appropriate;

(h) an identification of the values reflected in the tax return of the transactions specified in (d) above, including identification of any difference between those values and the values for the same transactions in the accounts of the business prepared for general reporting purposes.

4. The Member State would not necessarily impose a penalty for failing to make documentation available if the conditions described in paragraph 2 above were not met. Whether a penalty would be appropriate would depend on the particular circumstances.

5. The Member State could require a business to make documentation available going beyond that listed in paragraph 2 above. The Member State should not impose any penalty on a business for failing to make such additional documentation available if the documentation:

(a) was not available at the time the tax return was due to be made, but

(b) was made available to the tax administration within a reasonable time after the tax administration had made an appropriate request, and

(c) was made available in a reasonable manner.

6. The reasonable time referred to in paragraph 1(b) above should not be less than 30 days.

7. The reasonable time referred to in paragraph 4(b) above should not be less than 90 days.

8. The reasonable manner referred to in paragraphs 1(c) and 5(c) above:

(a) can include a specification of the language in which the documentation should be made available;

(b) should not otherwise insist on the documentation being made available in a particular form if the business could make it available in a reasonable manner in another form.