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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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Table of Contents

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 / "MASTERFILE" CONCEPT

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.

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. The issue of reducing compliance costs is becoming even more important following the recent decisions of the European Court of Justice (cf. Lankhorst-Hohorst GmbH, No. C-324/00) which ruled that different tax treatment of non-domestic companies as compared with domestic companies is generally discriminatory. In response, 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 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. The result is a waste of time, effort and expense.

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. Three different concepts are discussed in chapter C of this paper:

(i) a code of best practice;

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

(iii) a masterfile concept, i.e. standardised and centralised documentation (integrated global documentation).

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.

[*Please note: the following chapter is to be amended in the light of the discussions on document JTPF/004/2004/EN***]**

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).

[*Please note: the following paragraph is to be amended in the light of the discussions on document JTPF/005/2004/EN***]**

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. 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

44. 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.

45. 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.

46. 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.

47. 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.

48. 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.

49. 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."

50. 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.

51. Each of the documentation concepts as presented in paragraph 18 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.

52. 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.

53. 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 analysis

iii. contractual terms

iv. economic circumstances; and

v. business strategies.

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).

54. 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

55. 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.

56. 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.

57. 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. POSSIBLE CONCEPTS OF EU-WIDE DOCUMENTATION

I. Best Practice

58. 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.

59. 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.

60. 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

61. 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.

62. 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.

63. 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.

64. 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 is to be amended in the light of the discussions on document JTPF/003/2004/EN***]**

[III. Centralised (integrated global) Documentation ("Masterfile Concept")

65. 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 ("masterfile") that could serve as the basis for preparing specific local country documentation from both local and central sources. This "masterfile" would provide a "blue print" of the company and its transfer pricing system that would be relevant for all Member States concerned. The "masterfile" should follow the economic reality of the enterprise and should consist as far as possible of information that is already available in the group (for example, for management control purposes). 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.

66. The framework of such a "masterfile" should consist of the following items:

    a) description of the business;

    b) the group's organisational structure;

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

    d) description of the controlled transactions;

    e) characteristics of property and services;

    f) functional and risk analysis;

    g) comparative analysis;

    h) risk assessment questionnaire

    i) contractual terms;

    j) economic circumstances;

    k) business strategies; and

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

    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.

67. The masterfile should include an undertaking by the taxpayer to provide within a reasonable time frame, upon request, such information as is necessary for a

Member State's tax administration for carrying out the provisions of the Arbitration Convention or the relevant Double Tax Convention or of its domestic laws.

68. The contents of the documentation in the masterfile 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.

69. 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.

70. 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.

71. The concept of a masterfile 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 masterfile 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 the masterfile.

72. 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 Different Concepts

73. 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.

74. Business and tax administrations may also have different perspectives on the pros and cons of the various documentation concepts. In order to facilitate further discussions on the documentation concepts, the pros and cons of the different concepts are summarised in a quantitative manner in the grid on the next page. The order is not meant to indicate any priority.

Question 1: Do Members agree with the findings in the following grid ?

Question 2: Which elements should be added to the pros and cons of the various concepts?

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 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 taxpayers • less flexibility to decide what documents may be relevant For tax administrations • less flexibility, i.e. requires agreement on common set of documentation • simultaneous revision in all MS necessary
Standardised and Centralised Documentation / *Masterfile* (in addition to standardised documentation)	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

D. PROPOSED RECOMMENDATIONS FOR DOCUMENTATION RULES

I. Timing - Preparation and Submission of Documentation

75. 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.

76. 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.

77. 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.

78. 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.

79. 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.

80. 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.

81. 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.

82. 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 that 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 if challenged during a tax audit.

II. Application of Documentation Rules

1. Aggregation of Transactions

83. 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 often situations where 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.

84. 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 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

85. 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.

86. 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.

87. 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 request information concerning transactions between its parent company B in country B and its affiliate C in country C?

88. 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. [*redundant, see para 85 b*)]

3. The conduct of the Tax Administration

89. 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) not request documentation about transactions that are not under review; and

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

90. 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[1]

91. 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

92. 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.

93. 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 should be given the possibility to provide a translator to give explanations.

6. Penalties

94. 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.

95. 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.

[1] On 6 May 2003 the Commission adopted a new Recommendation 2003/361/EC regarding the definition of small and medium-sized enterprises (OJ L 124, 20.5.2003, p. 36). At EU level, small and medium-sized enterprises are generally defined as an enterprise which has fewer than 250 employees and an annual turnover not exceeding EUR 50 million or an annual balance sheet total not exceeding EUR 43 million, and in which no enterprise or enterprises which themselves are not small and medium-sized enterprises own 25% or more of the capital or of the voting rights.

96. 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.

97. 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.

9. Application to Permanent Establishments

98. The proposed recommendations on documentation requirements as described above should also apply to transactions between a head office and a permanent establishment.