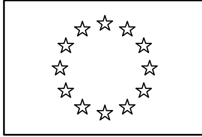

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EU JOINT TRANSFER PRICING FORUM

Draft Secretariat Working Paper on Risk Assessment

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Working Paper

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I. Introduction and context

1. Globalisation complicates taxation issues and the ability of tax administrations to track down trade and income flows. By increasing significantly the amount and type of income earned abroad, globalisation also reduces the ability of tax administrations to verify the accuracy of taxpayers' returns. In combination with only limited resources available tax administrations need to maximise administrative efficiencies.

2. Enterprises, on the other hand, are confronted with various and often extensive documentation requirements and are also more and more exposed to penalties for non-compliance with such documentation requirements or the arm's length principle.

3. At the meeting of the EU Joint Transfer Pricing Forum on 11 December 2003 the Forum, therefore, agreed by consensus to examine further the issue of risk assessment in the context of documentation requirements. It was also agreed that the discussions should include but not be confined to a "risk assessment questionnaire".

II. Definition and objective of risk assessment [management]

i) General Definition

4. Being mindful that "risk" is a subjective term, risk management can generally be defined as a formal process whereby risk factors for a particular context are systematically *identified*, *analysed*, *assessed, ranked* and *provided for:*

   - ***Analysing*** both the enterprise and the environment (tax laws, tax rates, industry sector specifics etc.) faced;
   - ***Identifying*** potential risks and then
     - *estimating* the risk's probability of occurrence;
     - *estimating* the spread (or confidence level) of that probability, taking into account, for example, the particular industry sector;
     - *estimating* the associated level and spread of exposure in monetary terms, also considering other factors such as legal requirements;
   - ***Assessing*** the risk;
   - ***Ranking*** the risks; and
   - ***Deciding*** what risks are to be addressed or provided for, based on the probability of the risk, the level of exposure and the cost effectiveness of reducing that exposure relative to other uses for the resources employed (opportunity costs).

5. In terms of taxation risk assessment means, simply speaking, *assessing the amount of tax that is likely to be at risk.*

ii) Concept and Objectives from tax administrations perspective

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

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

iii) Concept and Objectives from business perspective

8. Identifying *before the fact* specific transactions where establishing an arm's length transfer price is most difficult and where tax administrations are likely to examine in depth, may help taxpayers pro-actively concentrate on those transactions when making an effort to set their transfer prices at arm's length. These "risk" transactions may also require more detailed explanations and documentation to be made available *after the fact* in order to achieve the main objective of risk assessment for taxpayers, i.e. to avoid being exposed to double taxation and penalties.

9. For taxpayers, a risk assessment could also help focus on necessary improvements in their transfer pricing system. 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.

iv) Common Objectives for taxpayers and tax administrations

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

11. However, to achieve this, tax administrations must be prepared to give due consideration to the factual data provided by the taxpayers and the taxpayer must be prepared to produce theses data in good faith. The more common understanding there was between businesses and tax administrations about the basis of risk assessment, the greater would be the benefits for all concerned. If there was an existing agreed procedure for reviewing risks with a company this would be particularly helpful in questions of transfer pricing.

12. To be mutually beneficial risk management procedures should be regularly monitored and reviewed against international best practice benchmarks. Tax administrations and business are, therefore, encouraged to share data and research techniques and outcomes. They would thus be able to learn from each other building on each others efforts, rather than working independently. This would allow the joint development or refinement of risk assessment methods and enhance building confidence.

Question 1: *Do Members agree with the above definition and objectives of risk assessment* [*management*]*?*

III. Risk Assessment as a case selection tool for tax administrations

13. In most Member States large multinational enterprises are consistently audited for tax purposes. As regards SMEs, however, tax administrations have to either select cases at random, i.e. using a statistical approach, or on the basis of their tax risk profile. Targeting techniques in the context of case selection, indicating the possibility of non-compliance, have been developed by tax administrations using a variety of approaches. These include, for example, matching:

    - return form, balance sheet or profit and loss account data against external data (e.g. industry data);
    - return form, balance sheet or profit and loss account data against audit or risk assessment results of similar industry returns;
    - external data against external data to generate possible cases.

14. These techniques have been used to increase the likelihood of selecting the most non-compliant from the larger pool of generally compliant taxpayers. Analysing financial ratios and data is among the most commonly used targeting technique and is, therefore, described in more detail in chapter IV below.

15. The use of such targeting techniques may bring with it an increased requirement for a documented, more formal, risk assessment [management] process that enables targeting decisions to be defended against complaints of bias, unfairness and unjustified administrative burden.

IV. Analysing financial ratios/data for case selection purposes

16. Tax administrations use all kinds of instruments and factors to select taxpayers for examination. These include methods which seek to predict the likelihood of a taxpayer or a group of taxpayers being non compliant by using comparisons over time or across a population (e.g. across an industry) of a number of key financial

performance trends and indicators. Some of these trends and indicators can include the following, which are explained in more detail in appendix A:

- Horizontal Analysis;
- Vertical Analysis;
- Profitability Ratios (including gross profit margin, net profit margin, Berry ratio [gross profit/operating expenses]);
- Capital Structure Ratios (including gearing, net debt cover, net interest cover).

17. Most of these indicators are relatively straightforward and under US GAAP and UK accounting standards, tax administrations can determine them easily using the company's balance sheet or profit and loss account. Under IAS it may be more difficult to find these indicators and in some cases adjustments need to be made for the ratios to be comparable.

18. Generally, differences between accounting or book profits and taxable income will usually occur because of the basic differences in accounting and tax concepts and because there are usually some legal preferences available to taxpayers under applicable tax laws. It has been contended that levels of technical compliance may be effectively measured by examining the gap between accounting profits and taxable income.

19. The most appropriate set of ratios will vary, depending on the type of taxpayer being examined (e.g. the type of industry) and the area of risk being focused upon. For example, performance/profitability type ratios are arguably more appropriate when focusing on profit shifting.

20. A typical approach to establishing performance benchmarks for a taxpayer is to calculate the mean, or some other appropriate statistic such as the trimmed mean, median or mode, for each of the corresponding attributes of the data set. The statistics to be preferred will depend on a number of factors, which include the reliability of the underlying data, the variability of the corresponding attributes across the members of the population, the degree to which the members of the data set represent a homogeneous population, and the theories underlying the uses of the attributes as performance benchmarks. These statistics can then be used as benchmarks for comparing the performance and compliance behaviour of individual taxpayers.

21. A good reason for undertaking analysis of compliance by using data external to the tax administration is that data are not limited to tax return data, and therefore measurement may not be subjected to the time lags associated with the lodgement and processing of tax returns. At the larger end of the market, typical sources for the basket of information that may be used in ratio and other compliance analyses include the taxpayer's published accounts, external commercial databases,

newspaper and other media reports, other law enforcement agencies' reports and databases, and of course the tax returns themselves.

22. It is axiomatic in compliance research that multiple measures of data points allow better estimates both of data precision and data reliability. Therefore, comparisons of internal and external data may prove useful.

23. The ratios have to be compared with standard financial ratios of the industry sector in which the company operates. Reference can be made to publications and publicly available databases.

24. As with other methods, there are problems in the application of this methodology with identifying, isolating and quantifying the effects of a range of global, pan-European and domestic factors which may influence the taxpayer's performance.

25. Further, data is often only available in aggregate form. The only feasible way to use such data is segmentation of the tested party's business lines and to conduct categorical matching rather than case by case matching. Further, with aggregated financial data, tensions may exist where information provides two or more opposing interpretations, e.g. one ratio set indicates a remarkable improvement over time and another shows a small, or even no improvement. It may, therefore, be preferable to limit the outcomes from this methodology to a more qualitative assessment of compliance levels (rather than quantitative).

26. Some experiences from preliminary use of this methodology have indicated that it is best used in a mix of qualitative and quantitative ways to measure a company's performance longitudinally over time. With a well segmented market approach by tax administrations, the effects of some of the limitations may be minimised by the practical knowledge held by tax officials and particularly field auditors and their understanding of their industry segment taxpayers.

27. At first sight, the use of financial ratios and data may give the impression that tax administrations use industry averages etc., which is clearly rejected by the OECD Transfer Pricing Guidelines. However, in this context, ratios etc. are only used as a screening and selection technique considering that obtaining transaction-based material for selecting and prioritising issues for an in-depth examination is difficult.

Question 2: *Do Members share the assessment in chapters III and IV?*

V. Risk Assessment as a tool for specific inquiries and tax audits

28. Following a risk assessment on the basis of its tax return, balance sheet, profit and loss account, other taxpayer information, including [possibly] a basic risk assessment form/questionnaire to be attached to the tax return, and external data, a taxpayer may have been selected for examination. Such an examination may take the form of specific inquiries or a tax audit.

29. In order to limit the efforts and costs in examining a specific case another risk assessment may prove helpful. Such a risk assessment may need to be more detailed than a risk assessment made only for case selection purposes. In any case it needs to be tailored to the specific industry and company faced. This implies that questions that are not relevant in a specific case should not be asked.

VI. Risk Assessment Process

30. Transfer pricing enquiries and audits can be enormously resource intensive for both companies and tax administrations. Undertaking a detailed risk assessment, however, helps reducing the amount of enquiries and audits, because the mere presence of cross-border transactions between associated entities is not in itself sufficient reason to initiate a transfer-pricing examination, even if the amounts involved in the transactions are substantial.

31. For example, a car distributor may purchase €1bn of cars from its foreign parent company, but if the company's net profit is in line with commercial experience in the car distribution industry, there may be no substantial transfer pricing risk.

32. Also, in cases where a taxpayer has made reasonable efforts to determine its transfer prices in accordance with the arm's length principle and has prepared good and effective documentation, the tax administrations may have less reason for an in-depth transfer pricing scrutiny. By contrast, where the taxpayer provides only vague, useless or inadequately founded information on its transfer pricing, an in-depth examination may be necessary.

33. Risk assessment can thus be used as a means to reduce a taxpayer's documentation requirements. Reaching common understanding between tax administration and taxpayer on the "important" tax issues, i.e. the where a significant amount of tax is at risk, would enable the taxpayer to concentrate its documentation on those risk areas.

34. The risk assessment may show that it is not appropriate or feasible to review all cross border transactions in a single enquiry, particularly for large complex groups. In a pharmaceutical company for example, it may be appropriate to focus on the transfer pricing issues arising from a single drug. In a financial concern it may be appropriate to focus on a single business stream, say fund management, but not capital markets. In an industrial conglomerate there may be little overlap between different businesses so it may be appropriate to deal with them separately.

35. In a large multi-national enterprise (MNE) the high value-adding activities can be located in any part of the group. Depending on the functions and role of the company, it may not always be necessary to know a lot about the rest of the group. For example if the company is a distributor, it may be appropriate to establish the arm’s length price by examination of comparable uncontrolled transactions of independent distributors in the same jurisdiction which would not necessarily involve analysing the results of the worldwide group.

36. Regard should be given to both the potential tax at risk and the level of difficulty in establishing the arm's length price. Where, for example, the cost base is agreed to be €5m in a case where an arm's length cost plus percentage is agreed to be the appropriate method, each 1% increase in the mark up adds only €50,000 to profits. Given the difficulties that can sometimes arise in establishing an arm's length mark up, an enquiry into whether the cost plus percentage should be, for example, 11% rather than 10% may well not be appropriate. Where on the other hand a company makes an interest free loan of €1m to a well capitalised affiliate, the potential adjustment may still only be in the order of €50,000 - €100,000, but such a case could well merit enquiry because of the relative ease of identifying an arm's length price.

37. A risk assessment could, for example, include:

- a review of any previous transfer pricing papers concerning the enterprise;
- a detailed examination of multiple years' consolidated group accounts and of accounts of individual domestic and appropriate foreign entities;
- consideration of the group structure and identification of tax haven/shelter countries;
- a review of industry trends, details of the company's place in its sector, and recent developments within the group (new acquisitions, new locations, etc);
- a review of databases for multiple year data and potential comparables;
- consideration of cross-reference information;
- a review of information from treaty partners.

38. A *functional analysis* as described in paragraphs 1.20 to 1.27 of the OECD Transfer Pricing Guidelines may be a useful tool to identify risk areas in transfer pricing. In dealings between associated enterprises compensation should generally reflect the functions that each enterprise performs (taking into account the risks assumed and assets used).

39. A straightforward and often used method for measuring compliance is to compare changes in items on taxpayer return forms from period to period to deduce changes in compliance levels. The applicability of this 'simple' methodology is, however, *questionable* in a real world environment where there are numerous factors that impact on a taxpayer's performance over time. At the large end of the market, these factors are often from global influences on income and expenditure, influences often beyond the researcher's ability to *readily* identify and measure. Examples of these factors may include corporate restructuring (e.g. mergers and acquisitions), costs associated with establishing new markets, and new legislative and administrative policies at home and offshore both of a tax and non-tax kind.

40. If such pre-enquiry work seems excessive in a particular case this may be an indication either that the case is not suitable for a transfer-pricing enquiry, or that any enquiry should have limited scope.

41. Even after using risk management techniques to avoid or reduce the risk it is likely that a *residual risk* will remain and have to be "retained". If the residual risk is still significant, it may be planned for on a contingency basis.

VII. Risk Indicators

42. Clearly defined risk indicators may point to tax areas worthwhile examining more in-depth. Such indicators are, for example:

- Instances of mismatches between the likely scale of tax haven operations and the level of profits allocated to them (although the existence of transactions with affiliates in low tax areas may act as an important indicator, potential transfer pricing issues should not be ignored simply because the other party is in a normal or even high tax rate jurisdiction);
- Differences in effective tax rates;
- Profit margins are lower than in the group generally and there are reasons to believe that this should not be the case;
- Profits do not reflect the functions performed (taking into account assets used and risks assumed);
- The company possesses the resources to generate high margin profits yet produces only a routine low margin profit;
- Intangibles e.g. trade names, know-how, patents etc.
- Royalty or management fee payments that don’t appear to make commercial sense AND which substantially impact on taxable income;
- Poor performance over a number of years when there is no obvious prospect of super profits in later years to justify the risk of continuing losses;
- Any period in which changes in intra group contractual arrangements purport to adjust the risk profile, and hence the reward, e.g.:
    - distributor becomes commissionaire (AND net profits fall away);
    - full manufacturer becomes contract manufacturer;
- R&D activities that once generated royalties move to contract basis;
- Cost sharing arrangements introduced.

43. Risk indicators are arguably linked with the amount and accuracy of documentation necessary to demonstrate a taxpayer's transfer pricing. If, for example, a taxpayer's royalty rates for its transactions with associated enterprises are average industry rates, less documentation may be required as compared with a situation where royalty rates fall outside the range of industry average.

Question 3: *Do Members agree to discuss the issue of risk indicators and should examples as described above be included?*

VIII. Framework for the discussions of risk assessment in the JTPF

44. With reference to the discussion in the JTPF on the different concepts of transfer pricing documentation risk assessment could be considered under one of the following concepts:

- *Best practice*, i.e. taking the best elements in Member States' tax administrations and businesses approach and recommending this as best practice; or

- *Standardised risk assessment*, i.e. a uniform risk assessment procedure (and possibly risk assessment forms/questionnaires) within the EU.

45. A best practice approach, which is the least prescriptive common approach, seems to offer advantages as regards flexibility. It would avoid the problems associated with standardisation, e.g. reaching agreement on a uniform risk assessment process or even risk assessment form (see chapters IX to XI) and revising it simultaneously in 15 (or even 25) Member States. On the other hand, a standardised and, even more, a centralised risk assessment would prevent fragmentation and reduce compliance burdens and provide taxpayers with more certainty.

Question 4: *Which framework for the discussion of risk assessment do Members favour?*

46. The discussion of risk assessment in the context of both (i) case selection and (ii) identification of specific areas where tax may be at risk (which may warrant specific inquiries or an in-depth examination during a tax audit) could be limited to transfer pricing issues or, alternatively, cover all tax issues of a taxpayer.

Question 5: *Do Members agree that considering the remit of the JTPF the Forum should discuss risk assessment only in the context of transfer pricing?*

IX. Relation between risk assessment and documentation / possibility of a risk assessment form/questionnaire

47. From a tax administration's point of view a risk assessment serves two main purposes: (i) taxpayer selection and (ii) identification of tax risk areas in connection with a specific inquiry or tax examination. If a tax assessment form/questionnaire were to be used, this lends itself to the following two-layer approach:

- one limited form [questionnaire] to be prepared [automatically] when the tax return is made to enable the tax administration to identify "risk enterprises" and make specific enquiries into the tax return;

- one more detailed form [questionnaire] to be prepared [on request] when the tax audit starts to enable the tax administration to identify "risk areas" that warrant a more in-depth examination.

48. It should be noted, however, that this paper is not meant to affect Member States' existing legislation on documentation requirements, e.g. when documentation has to be prepared and submitted. These issues are to be dealt with in the broader context of documentation requirements.

Question 6: *Do Members agree with the two-layer approach as described above?*

Question 7: *Considering the decision taken on question 5 above, should the same narrow or broad approach be taken for both layers of risk assessment, i.e. (i) case selection and (ii) specific inquiries / tax audit?*

49. A risk assessment form or risk assessment questionnaire may constitute an essential part of the risk assessment process. The use of standardised risk assessment forms/questionnaires by tax administrations should nevertheless be optional as tax administrations may wish to use other means to assess tax risks. However, the Forum should work out as much common ground as possible on the contents of risk assessment forms/questionnaires in order to facilitate risk assessment processes for both tax administrations and business and reduce businesses' compliance costs.

Question 8: *Do Members agree that tax administrations should be able to choose whether or not to use risk assessment forms/questionnaires and require their completion by taxpayers?*

50. If a tax administration wishes to use a risk assessment form/questionnaire for specific inquiries or as an audit tool, it needs to be discussed whether the rules

concerning preparation and submission etc. that apply to transfer pricing documentation should also apply to a risk assessment form [questionnaire] and whether a risk assessment form [questionnaire] should be an integral part of the transfer pricing documentation.

> ***Question 9:*** *Should a risk assessment form for specific inquiries and tax audit purposes (second layer) be part of the transfer pricing documentation and fall under the same procedural rules or should it be treated differently?*

X. Scope of a Risk Assessment Form [Questionnaire]

51. A risk assessment form [questionnaire] could generally be prepared on an aggregate basis including data of all entities of a group in a given jurisdiction ("per country approach") or separately for each single entity resident in that jurisdiction ("separate entity approach"). Another possibility would be to group several entities according to specific criteria, e.g. by functions such as manufacturing, distribution etc.

52. As regards the foreign associated enterprises the issue is whether there should be one separate form [questionnaire] for each foreign associated enterprise that has dealings with the domestic taxpayer. Care must be taken, however, that, for example, preparing a risk assessment form for each single entity of a domestic multinational group including separate forms for each foreign associated enterprise that has dealings with any domestic entity of the group could be very onerous and increase the taxpayer's compliance costs.

> ***Question 10:*** *Which of the multiple alternatives as described above do Members prefer taking into account the compliance costs involved?*

XI. Contents of a Risk Assessment Form [Questionnaire]

53. A list of possible nominal amount items to be included in a risk assessment form for *case selection* purposes can be found (as a starting point) in the appendix to the income tax return concerning controlled foreign transactions that has been developed by the Danish tax administration (see Appendix C to this working paper). This list, however, is not meant to be exhaustive.

54. A risk assessment form to be prepared by a taxpayer on request of a tax administration for *specific inquiries* and in-depth examination during *a tax audit* may , for example, include, but not be limited to, the following items:

    - Differences in marginal effective tax rate;
    - Royalty rates;
    - Distributor margins, manufacturer margins;

These items are, however, not meant to be tools for making transfer pricing adjustments without further consideration.

Question 11: *Do Members agree that developing risk assessment forms/questionnaires that could be used by tax administrations may be helpful?*

Question 12: *Are Members of the opinion that considering the remit of the JTPF this paper sufficiently covers all issues to be discussed or would Members like to add some additional discussion topics ?*

Appendix A: Financial Statement Analysis

(taken from OECD document DAFFE/CFA(99)51)

Horizontal Analysis

Horizontal Analysis is the study of changes in comparative financial statements from year to year. It highlights percentage changes in an item over time. The percentage change is calculated by dividing the amount of the change by the base year amount. Percentage changes must be evaluated in terms of the item's relative importance to the company as a whole. Percentage changes are not calculated where the base year amount is either zero or negative.

A comparative **profit and loss statement** shows changes in sales, investment income, selling & administrative expenses, gross & net profits, etc. A comparative **balance sheet** will show changes in assets, investments, borrowings (long and short term), inventories, creditors, capital, etc.

Trend percentages are an important form of horizontal analysis. They are important indicators of the direction a business is taking. To gain a realistic view of the company, it is often necessary to examine more than just a 2 or 3 year period (5 years is usual). The item in the base year assumes 100%, and each subsequent year item is expressed as a percentage of that base amount.

Vertical Analysis

Vertical Analysis of a financial statement reveals the relationship of each statement item to the total (usually net sales & total assets), which is the 100% figure. Again, percentage changes must be evaluated in terms of the item's relative importance to the company as a whole.

Percentages on the **profit and loss statement** are computed by dividing all amounts by net sales. The gross profit percentage is one of the most important pieces of information in financial analysis because it shows the relationship between net sales and cost of goods sold. A company that can steadily increase its gross profit percentage over a long period is more likely to succeed than a business whose gross profit percentage is steadily declining.

The **vertical analysis** of the balance sheet shows all amounts as a percentage of total assets or the sum of liabilities and shareholder's equity. A decrease in current assets may make it difficult for the company to pay its bills.

Ratio Analysis

Ratios are important tools for financial analysis. Ratios provide a means of converting raw figures into figures that can be compared for the one entity over a period of years and compared with ratios calculated for the industry (often readily provided by external information services).

Some type of ratio comparative analysis could be developed on the population of a particular industry. Traditional accounting ratios can be calculated and obtained from annual reports, external industry surveys, analytical reports and usually external and internal databases. The ratio analysis process can:

- develop an understanding of performance of an industry;
- compare operations/performance of a company against industry benchmarks;
- be used to make a comparative analysis over a period of time;
- confirm or assist in the risk assessment process.

One method is to use "**Profitability Ratios**" to allow for comparison against industry averages. In respect to a company that can be aligned to an industry sector annual reports or other financial data can be used to calculate the following ratios:

Gross Profit Margin [gross profit/sales] x 100%

This ratio is from the vertical analysis of the profit and loss statement. This measures the level of profit being made on sales. Those businesses depending on high volume will have low gross margins and those depending on margin should have higher gross margins. The higher the rate of return, the more net sales are providing profit to the business and the fewer net sales are absorbed by expenses. Gross profit is net sales less costs of goods sold (COGS). This ratio does not include selling, administrative or financial expenses.

Analysis of the profit margin depends on the industry involved. For example, it is expected that a supermarket chain would have a low profit margin as the turnover of goods is very large and sales volumes are high, whereas an aircraft manufacturer would have a higher profit margin with lower turnover of sales.

Net Profit Margin [net profit/sales] x 100%

This ratio is also from the vertical analysis of the profit and loss statement. Net profit is gross profit less selling, administrative and financial expenses. It calculates the

proportion of sales that represents net profit. The rate should be compared with other companies or an industry average to be more useful.

Berry Ratio [(sales - cost of sales)/operating expenses] x 100%

The Berry Ratio gives an indication of the profitability of a company. It calculates the proportion of gross profit that is available to cover operating expenses. A ratio lower than 100% is poor as it means the company is unable to cover its expenses. It may mean a market penetration strategy is in place. Berry ratios below 100% are not sustainable in the long term.

EBIT Margin [operating profit before tax + interest]/sales x 100%

EBIT (Earnings Before Interest and Taxes) is a commonly used profit measurement. It measures the profit earned independently of how an entity is financed and so makes profit more comparable between entities with different financing structures. Again, losses are not sustainable in the long term.

Return on Assets (ROA) [(net profit + interest)/average total assets] x 100%

This ratio measures the success a company has in using its assets to earn a profit. A rule of thumb comparison is to compare it with the rate of interest which could be earned if all the assets were converted into cash and placed on deposit. The levels of ROA will vary between industries. Some industries require significant assets to generate profit (i.e. mining), while others probably do not need to acquire many assets. The reasonability of the ROA should be compared with industry averages.

The use of both net profit and EBIT ratios, reflecting results before and after financing costs, may help to explain the differences caused by their respective debt levels.

All or some of these ratios would be calculated on the population of the particular industry or group of similar industries. This population could, for example, be ranked and grouped into quartiles for that industry or comparable industries. The industry average of the above ratios could, for example, come from the 25% to 75% range.

The comparison of the bottom 25% to the industry average might give the first cut of high to low risk companies. Judgement must be used to ascertain why a company ranks in the lowest quartile of a particular industry and/or lowly compared to the industry average. Some explanations could include :

- the company has a history of bad management;
- the company has a market penetration strategy;
- the company is new to a particular industry;

- the company is heavily involved in R&D, capital expansion and/or promotion.

Further ratio analysis could include "**Capital Structure Ratios**" such as:

- **Gearing %** [Debt / (Debt + Equity)] x 100%
- [Net Debt / Equity] x 100%
- **Net Interest Cover** EBIT / Net Interest and Finance Lease Charges

Other ratios more directly related to taxable income may include:

- Taxable Income / Shareholder's Funds
- **Effective Tax Rate**
  (NB: care must be taken as there is many variations of effective tax rates. Current year tax provisions should not be used. Where tax is paid in a subsequent period, but is not readily available through internal accounting systems, a reasonable estimate may be made by using the tax paid figure from the sources and applications section of a company's published accounts in year X + 1, and compare that to accounting profits before tax in year X.)
- (Operating Net Profit - Taxable Income*) / Shareholder's Funds
  * Excluded carried forward losses and intra group dividends
- [(Net Profit - Taxable Income) / Net Profit] x 100%
- [(Net Profit - Taxable Income) / Total Operating Income] x 100%
- Taxable Income / Total Income

Other possible ratios could include, for example:

- Gross Profit / Total Operating Income
- Profit before Tax / Total Operating Income (excluding proceeds from non-current assets)
- Net Profit / Total Turnover of *Domestic Company*
  ***compared** to*
  Net Profit / Total Turnover of *Foreign Companies* within the same group.

The most appropriate type of ratio will vary depending on the type of industry and the area of risk that needs to be confirmed.

Limitations

Ratios need to be evaluated in the light of other information about the company and its business (i.e. increased competition, slowdown in economy, etc). Ratios may indicate that something is unusual, but will not be able to provide any detail of what it may be or how to address it. Ratios can be misleading because of many mitigating factors, therefore a full analysis of the ratio result is necessary if it is relied upon to validate, confirm or indicate a risk assessment finding.

Appendix B: Code of Best Practice on Risk Assessment

(Contribution from Roy Warden)

1. Transfer pricing rules apply, broadly speaking, where a business has transactions with a business with which it is related. In some circumstances, the rules require the actual results of those transactions to be adjusted to "arm's length" results for the purpose of calculating taxable profits or losses.

2. Where two businesses are related with each other, the amount of the taxable profit of each can be significantly affected by the results of the transactions between them. There is scope, either through negligence or manipulation, for the taxable profit of a business to be significantly depressed if the results are accounted for in an inappropriate way. A decision by the tax administration whether to make an enquiry into a particular tax return needs to take account of this possibility.

3. A transfer pricing enquiry can be complex and costly both for the tax administration and for the business. One should not be undertaken lightly without due regard to the nature of this complexity or a fully considered assessment of the amount of tax that is likely to be at risk.

4. The establishment of an appropriate "arm's length" result requires judgement as well as knowledge on the part of a business when making its tax return. The same principle applies to the tax administration when deciding whether to make an enquiry into that aspect of a return.

5. The length to which a business needs to go to establish whether a result is an appropriate "arm's length" result depends on a number of factors, including the amount of tax at stake. Where the amount of tax at stake is large, the business can expect that the tax administration may take an interest in whether the results have been established in appropriate way and the business may well want to take steps to ensure that it has adequate evidence to support its position. But where the amount of tax at stake is not large, the business is entitled to expect that the tax administration will not make detailed enquiries and will not request excessive amounts of evidence.

6. As far as transfer pricing is concerned, it is more likely that significant amounts of tax will be at stake as the result of manipulation than as the result of negligence. In deciding, therefore, whether to make a transfer pricing enquiry into the tax return of a business which has transactions with a business with which it is related, the tax administration can be expected to pay particular attention to the opportunity for securing a tax advantage. This opportunity will depend, to a large extent, on the tax position of the related business. Where the marginal effective tax rate borne by that other business is the same as, or similar to, the rate borne by the business in question, that opportunity will, in most cases, be low.

7. For example, where a business in one Member State has taxable profits on which it pays tax at 30 per cent, and has transactions with a related business (whether or not a business in the same Member State) which pays tax at 30 per cent or thereabouts,

the tax at risk in relation to such transactions is less likely to be significant than in cases where the related business pays tax at a low rate (including cases where the marginal effective tax rate is zero because of losses).

8. The amount of tax at risk in respect of transactions between businesses that are related to each other should be judged by reference to the tax to which the business whose tax return is being considered is liable. The tax to which the related business is liable is not directly relevant. It is, however, indirectly relevant in a very important sense since, as already explained, there is more opportunity to secure a tax advantage through manipulation where there is a significant difference between the marginal effective tax rates.

9. Where there is no, or minimal, opportunity to secure a tax advantage through manipulation, there is not likely to be a strong justification for the tax administration to make a transfer pricing enquiry.

10. In cases where the tax at stake is low, there is no need for a business to perform excessively complex calculations in order to establish an appropriate "arm's length" result. An approach that gives a broadly correct result is entirely acceptable even if it lacks precision. Such an approach is not an indication of any sort of negligence on the part of the business.

11. For example, in a low risk case where there is a debt outstanding between two companies that are members of the same group, and the amount of that debt varies during the course of a period, it might well be appropriate for a business to establish an appropriate "arm's length" amount of interest for that period by reference to the average amount of debt outstanding at a small number of appropriately chosen dates rather than by trying to establish the effect of every individual variation.

12. Because of the degree of judgement involved in establishing appropriate "arm's length" results, and the cost implications of a transfer pricing enquiry for both the business and the tax administration, it may well be sensible for a business to have a discussion with its tax office about transfer pricing issues before a tax return is made, or even before the transactions take place. It may be possible to agree an appropriate approach that will satisfy the concerns of both the business and the tax administration while ensuring that profits and losses are calculated correctly for tax purposes.

13. For example, where a company that is a member of a group provides management services to other group members, it might be possible to agree in advance an appropriate basis on which that company might charge for those services. This might involve charging the cost of providing the services plus a profit the size of which would be appropriate to the nature of the services. Having agreed such an approach, the tax office would not need to make transfer pricing enquiries into those transactions provided that they took place in the way that the company had explained.