

Possible content and structure of the JTPF's project on risk management

Working paper for the first Subgroup meeting

Brussels, 18 September 2012

About this draft:

This paper is drafted to build the basis for a first discussion by the risk management Subgroup on the possible content and structure of the JTPF's project on risk management. The result of this discussion will be presented to the JTPF at its next meeting on 25 October 2012.

Starting point of the paper is the work already done on risk management by the European Commission (EC), the JTPF and the OECD¹. The structure adopted in this paper follows the process of risk management developed by other bodies, mainly the EC.

The paper addresses the various aspects of risk management and considers where and what kind of further work might be done. It also picks up JTPF Members' suggestion to consider more concrete areas of future work at the various stages of the general risk management process, e.g. improving the EU CoC on documentation, the exchange of information or multilateral controls.

Structure/content suggested:

Note:

At this preliminary stage, this paper intends to form the basis for a first discussion.

The JTPF will have to decide what the key priorities of the project should be. It will discuss how to combine general guidance on risk management, with focus on some relevant more specific items of risk management, as well as with other on-going JTPF projects such as monitoring.

The discussion at the Subgroup meeting should ideally result in proposals for concrete areas for future JTPF work.

The questions in the boxes generally aim at finding out whether a certain topic is considered relevant, whether there is already experience and how the JTPF might take it forward.

The invitation to comment/contribute is not limited to the content of the boxes.

¹ Sources and respective links are listed at the end of the paper

1. Introduction and Background

An introductory section may address the general background of the project and may be drafted on the basis of what is already said in section 1 of the discussion paper on further work in the area of transfer pricing risk assessment ("JTPF DD") (doc JTPF/011/2012/EN). Further, this section may develop the content and structure of future work.

2. General Outline

2.1. Definition

In this section a definition of risk management for the purpose of the project would be given. It may build up on what is already said in section 2.1 of the JTPF DD eventually supplemented by some conclusions from the introductory sections of the EC Guides from 2006 and 2010 and the OECD Study "Dealing Effectively with the Challenges of Transfer Pricing".

2.2. Objectives

The objectives of risk management are already considered in section 2.2 of the JTPF DD. This may be supplemented with the general conclusions in the introduction and Chapter 2 of the OECD Study.

2.3. Strategy/risk management process

Especially the 2006 and 2010 EC reports stress the importance of developing a strategy, i.e. a process on how the objectives described in the previous section will be achieved (the "how"). General thoughts about the value of a strategy can e.g. be found on p. 17 ff. of the 2006 Guide.

The issues arising for tax administrations with respect to transfer pricing ("TP") and the value of risk management in TP are described in the introductory parts of the OECD Study. Some conclusions may be adopted here.

Following the 2006 and 2010 EC Guides, a risk management process can be subdivided into the following broad steps (see e.g. the illustration on p. 51 2010 EC Guide):

- Identification of risks
- Analysis of risks
- Assessing/ranking risk (creating a risk picture)
- Treating risks
- Evaluation

In this context it may be clarified that risk assessment as the original headline of the JTPF project is generally understood as being only a part of risk management in general (see already section 2 JTPF DD).

The following sections in this paper adopt the structure outlined above

For discussion:

The five bullet points are considered as providing an appropriate structure for the following discussion and may also be adopted for the structuring a JTPF project.

Your views are invited.

3. Risks in TP and their identification

Sections 3.1 – 3.3 relate more to risk management in general and provide some kind of theoretical framework of risk assessment. Sections 3.4 and 3.5 address more concrete measures relevant/useful in the context of risk management.

3.1. Consideration of TP risks in general

This section may provide an overview and raise awareness of risks more generally. It may serve as the basis for the analysis in this project but also as general guidance for tax administrations, when considering a risk management process in TP.

3.1.1. Types of risks in TP

The 2006 EC Guide suggests starting with elaborating on the types of risks that should be subject to the risk management process. The types of risks described on page 21 of the guide – register risk, filing risk, payment risk and declaration risk – do not seem to be directly relevant for TP. Eventual future work on this topic may consist in attempting to describe the relevant risks for TP. Examples are the general risk that prices are not reported at arm's length but also the risk of ineffective administration of transfer pricing, creating unnecessary compliance burden, etc.

3.1.2. Levels of risk in TP

A further aspect to consider is the level at which risk can be identified (see e.g. p. 22 2006 EC Guide). The starting point for this evaluation may be the so called tax gap. The “tax gap” is the difference between the annual amount of taxes owed and the amount voluntarily paid on time.

This tax gap may be allocated to different levels, e.g. risky acts and risky actors or loss of revenue due to intended or non- intended incompliance with the arm's length principle.

3.1.3. Sources of risks in TP

In this section the sources of transfer pricing risks may be identified more generally. For taxes in general the 2006 EC Guide (p. 24) lists several sources as e.g. horizon scans, new legislation, random audits and data mining.

3.1.4. Approaches to risk identification in TP

Identifying the risks that will be addressed, their levels and the sources from which they arise require establishing a procedure. Certain procedures may be described here. A distinction is often made between "top down approaches" (comparing the taxpayer's profitability with overall profitability of the MNE group and in case of mismatch investigate further) and "bottom up" approaches (starting with certain cross border transactions)².

For discussion:

Your views/ideas and additional suggestions on sections 3.1.1 – 3.1.4 are invited.

3.2. Analysis of TP risk

This section would focus on the analysis of TP risk. An analysis requires the availability of information and the determination of indicators for TP risk. Additionally to the theoretical aspects on risk analysis, this section could also elaborate on more concrete aspects that might be considered in the context of the JTPF project.

3.2.1. Data/Information that is or should be available to build the basis for analysing TP risks

It is important to have good quality data available to form the basis for risk management. This section may start with a presentation of the general approaches for obtaining data/information (see e.g. p. 32, 2010 EC Guide) and then provide more concrete sources of data/information.

Sources of information generally relevant for risk management in TP could be:

- Balance sheet, tax return
This information should generally be available. Its content is usually determined by domestic or international law and not targeted to transfer pricing.
- TP documentation
TP documentation is the main source of information in TP. Nearly every MS

² (see p. 26 of OECD Study)

has its own documentation requirements. The JTPF developed the Code of Conduct for Transfer Pricing Documentation in the EU (see section 3.4.1.2 below on TP documentation).

- **Specific TP Questionnaires**
Some States send specific TP Questionnaires to taxpayers to receive additional information on their controlled transactions. These Questionnaires are sent to taxpayers routinely (see e.g. DK, p. 22, Annex A OECD Study) or after an initial review of the case (see e.g. South Africa p. 22 and Annex B OECD Study).

For discussion:

The JTPF may obtain further information about the experience with such questionnaires and their timing (e.g. from DK and PSM). If there is support for this source of information, a JTPF questionnaire may be developed to possibly supplement the work of the JTPF on TP documentation. This could be a concrete outcome of the project on risk management or be part of the monitoring exercise envisaged for the CoC on TP documentation.

Your views are invited.

- **Early contact/enhanced relationship**
Some tax administrations gain information from an enhanced relationship with the taxpayer, i.e. issues are ideally discussed when they arise. Enhanced relationship is also addressed in section 4.
- **Sector studies**
These studies may analyse certain business sectors with respect to their specific risks (see p. 72 2006 EC Guide). For transfer pricing, the result of such an analysis may help to identify business sectors with a relatively higher or lower transfer pricing risk but also certain risk areas within a certain sector.
- **Databases**
Information from commercial databases may also prove useful in identifying TP risks, e.g. if the financial results of a company are inconsistent with the results of comparable companies. The OECD Study (p.23) mentions the Forecasting Analysis and Modelling Environment (FAME), which takes information from a variety of sources. Regarding the use of electronic tools in general, see p. 84 of the 2006 Guide.
- **Customs data, data from patent offices, information disclosed in national and foreign Court cases, other information from the public domain, i.e. magazines, internet, etc.**

- Exchange of information between tax administrations
Information received from other tax administrations in general under a treaty, the EU Mutual Assistance Directive or from a special service like JITSIC (Joint international Tax Shelter Information Centre³) are generally useful sources of information.

For discussion:

Do you consider the use of these sources of information as helpful? Is there already information available in MS or the PSM that could be shared?

While all these sources of information may be useful, it should be discussed how the JTPF could take this work further.

3.2.2. Risk indicators in TP

3.2.2.1. Determining risk indicators

The availability of information forms the basis of risk analysis. The next step is the use of this information to determine the actual TP risk indicators. At the JTPF meeting in March 2012, Austria and the UK introduced their approaches for determining TP risk.

The OECD study introduces the approach to risk identification in Denmark (p. 22) and the internal process used in France (Annex 3). It also underlines at various occasions the benefit of using specialists (e.g. p. 26) and this might also be useful when identifying transfer pricing risk.

For discussion:

Your views on further areas of work in this respect are invited.

3.2.2.2. Risk triggers in TP

The process of identifying transfer pricing risks may result in features that generally suggest a transfer pricing risk. The OECD study already lists some features that may suggest a TP risk (p. 25). MS may also have determined certain risk triggers see e.g. slides 6 and 7 of the UK presentation at the March 2012 JTPF meeting (large royalty or management fees, a low worldwide tax rate, etc.).

For discussion:

Should we try to further develop such a list? May such a list of triggers also be used in the context of the CoC on TP documentation in the EU?

³ Details <http://www.hmrc.gov.uk/avoidance/aag-jitsic.htm>

3.3. Assessing/Ranking TP risks

3.3.1. General

After being identified, transfer pricing risks need to be assessed. Assessing the risks in this context means deciding on which risks can and should be "treated" and which not. Risk assessment may take place on a broad level, i.e. when deciding which cases should be further audited but also with respect to a certain case, i.e. when deciding which audit fields should have priority or be addressed at all. Finally a decision will have to be made about the resources that should be allocated to the case/ the audit field. Tax administrations may have different practices in this respect (see e.g. p. 37 (general) or p. 71 (NL) 2010 EC Guide)

3.3.2. Who makes the decision?

A further point that may be considered in the process of risk assessment is who finally decides about the assessment/prioritisation of risk. This may be done by the general management, by TP specialists or by a specific board or panel (see e.g. UK, p. 27 OECD Study).

3.3.3. Criteria

Assessing risks requires developing certain criteria for determining which risks and therefore which cases/audit fields should finally have priority. Criteria in this respect may be

- revenue impact, e.g. amounts at stake, one time or long term commercial relationships, implication for other transactions or transactions with other related parties etc.
- likelihood, e.g. the history of the taxpayer, the frequency of certain transactions, involvement of tax havens, etc.
- implications go beyond transfer pricing e.g. on other taxes or customs etc. .

For discussion:

Your views/ideas and additional suggestions on sections 3.3.1 and 3.3.2 and especially 3.3.3 are invited.

3.4. Treating TP risks

3.4.1. Reducing TP risks

The preceding sections address obtaining information, identifying risks and ranking risks. In addition to some general thoughts, this section lists concrete measures that may reduce tax risks from TP.

3.4.1.1. Clear legislation/guidance

Clear legislation and guidance is seen as a prerequisite for reducing TP risks. However, the fact that TP is based on a transactional approach which considers the facts and circumstances of each individual case and attempts to find comparable transactions between independent parties often sets limits to what can be applied generally. Nonetheless, the JTPF has provided clarity e.g. in the area of service provision between related parties by adopting the Guidelines for Intra Group Services and the Report on CCAs on Services not creating IP. The projected work of the Forum on compensating/year-end adjustments also falls into this category.

For discussion:

Are there other areas of guidance where the Forum could progress?

Would it be useful to consider in this respect the first statements in the public domain on the OECD project on intangibles according to which more and more cases in the future will be solved by applying a residual profit split method? If this is the case, do you think the JTPF should envisage doing further work on the practical application of profit split?

3.4.1.2. Clear documentation

The discussion at the JTPF meeting in June showed that documentation remains a major issue for TAs and PSM. Taxpayers criticise the amount of data requested by TAs and which may at the end not be used, TAs criticize that they are overwhelmed with information that is at the end not useful. This problem is also revealed by other bodies (see. e.g. p. 34 OECD Study).

The CoC on TP documentation in the EU adopted in 2005 addressed documentation. It seems, however, that there is still room for improvement.

For discussion:

Experience with the CoC on transfer pricing documentation may be discussed and the reasons why the situation did not improve as well as areas where/how improvement would be possible could be considered.

However, it should be kept in mind that the CoC will probably be subject to a monitoring exercise and an update may be done as part of this effort.

Do you have some general thoughts about whether and how a risk based approach could be implemented?

3.4.1.3. Advance rulings, APAs

Providing the possibility for addressing risks in advance by way of uni-, bi- or multilateral APAs is generally regarded as an appropriate tool for reducing TP risks. APAs provide the opportunity to address issues in advance and to benefit from a contemporaneous situation rather than trying to resolve the issues a long time after they arise. These agreements also provide the benefit for agreeing in advance which documentation/information will be needed rather than running the risk to produce documentation that will in the end not meet TAs requirements.

In 2007 the JTPF adopted Guidelines for APAs in the EU.

For discussion:

What is the experience with the APA Guidelines in the subgroup and is improvement needed? How could this be achieved.

However, we should keep in mind that the APA Guidelines may also be subject to a monitoring exercise and an update may be done as part of this effort.

3.4.1.4. Increase compliance

It is generally recognised that increasing voluntary compliance with tax law is a preferred situation. It is less resource intensive for TAs and taxpayers and contributes to a reduction of tax risks. Many efforts are made to investigate how voluntary compliance with tax laws could be increased (see EC 2010 Compliance Risk Management Guide). This guide evaluates from a general and a VAT and tax fraud related perspective which elements and measures may contribute to increase voluntary compliance.

For discussion:

Do you consider work on how to increase voluntary compliance as useful? How could the JTPF take such an approach forward?

3.4.1.5. Tax certificate

Some countries have implemented an approach where a certified auditor reviews a company's intra group transactions and issues a certain certificate confirming that no violation was found⁴. Under this program only a certain and limited percentage of companies will be audited within a short time frame to receive early security on their TP tax matters.

For discussion:

Do you consider such an approach as useful?

What, if any, work could be done in this respect by the JTPF?

3.4.1.6. Taxpayer's own risk assessment

Some States oblige their taxpayers to evaluate and disclose all TP related risks⁵. Risk factors in TP may be the availability of appropriate TP documentation, the selected TP method, the comparables, entity classification, audit history, other arrangements in place like APA and all other items that may impact the likelihood that a particular transfer price would not be sustained upon audit.

For discussion:

What are your experiences with this approach?

Do you consider such an approach useful at EU level?

3.4.1.7. Safe harbours

Safe harbours are often seen as a useful tool for simplifying transfer pricing and for reducing transfer pricing risks. The OECD is currently working on two aspects of this topic⁶, i.e.

- redrafting the currently quite negative language in paragraphs 4.93 - 4.122 of the OECD Guidelines on safe harbours, and
- providing sample memoranda of understandings for competent authorities to establish bilateral safe harbours.

⁴ See e.g. Greece: <http://www.pwc.com/gr/en/tax-services/news/assets/tax-certificates-aug11-eng.pdf> or [http://www.ey.com/Publication/vwLUAssets/Tax_Certificate_2011_oct.2011/\\$FILE/Greece_Tax_alert_October_2011.pdf](http://www.ey.com/Publication/vwLUAssets/Tax_Certificate_2011_oct.2011/$FILE/Greece_Tax_alert_October_2011.pdf)

⁵ E.g. the US: <http://www.irs.gov/businesses/corporations/article/0,,id=171443,00.html>

⁶ <http://www.oecd.org/dataoecd/39/46/50514053.pdf>

The project is currently at the stage of a first publication of an interim draft with an invitation to the public to comment before 14 September.

For discussion:

Do you regard safe harbours as a useful tool for reducing transfer pricing risks?

If so and depending on the outcome of the discussion at OECD level, do you think that on the basis of the sample MOUs in the discussion draft, the JTPF may promote at EU level certain safe harbours by way of recommendations?

3.4.2. Audit

While sections 3.1 – 3.3 address the general aspects of identifying and analysing transfer pricing risks, this section considers how the audit process itself can be structured in an effective way.

3.4.2.1. Establishing an effective audit process

The selection of the right cases for audit should be the result of the risk management approach described in sections 2, 3.1 - 3.3. The case selection may or may not be regarded as part of the audit. It is however important that a process is established by a tax administration that ensures the effective use of resources. The following examples are currently available:

- Presentations by the UK and Austria at the JTPF meeting in March 2012
- Chapters 2 and 3 of the OECD Study, especially the examples provided by Denmark and France

More generally, it can be distinguished between the initial and often internal stage of fact finding and the later stages of an audit. The following aspects of an effective audit are mentioned in different sources:

- The involvement of sector experts
- The value of early dialogue for agreeing on the scope and the next steps of the audit
- Real time working and enhanced relationship (see p. 44 OECD study and presentation by the Netherlands at the JTPF meeting in October 2011)
- Setting up a TP audit action plan or enquiry plan (p. 39 OECD Study)
- Sanctions (estimation, penalty) if taxpayer does not provide appropriate information (p. 41 OECD Study)

- Transparency about the internal process on TA and TP side when requests are answered or the responses are evaluated
- Involvement of external advisers (see box 9 p 45 OECD Study), e.g. valuation specialists
- Litigation and settlement strategy for TP cases (see box 11 p. 51 OECD study). Establishing a process for deciding whether to litigate or to settle the case
- Establishing other processes than litigation for settlement, e.g. US appeals office
- Specific audits, e.g. whole or partial desk audit, field audit field inspections unannounced visits, random audits computer audits, on site visits etc.
- Joint bi- or multilateral audits

For discussion:

How could this work be taken further by the JTPF?

Which of the items should warrant specific attention?

Should the possibilities of joint audits and their practical features be explored further?

3.4.2.2. Alternative dispute resolution

In case of disputes arising between the taxpayer and TA/TAs, the only thing that may often be needed is "a fresh pair of eyes", i.e. a neutral evaluation (see p. 46 OECD Study). This would be a non-binding unilateral or even bilateral process that may be offered before claiming for MAP.

For discussion:

Do you consider such a process as useful?

Which form could such a process take and do you think it is useful to establish something like this at EU level?

With respect to EU vs. non EU cases one may also think about a kind of case study discussion at JTPF level. This may be useful if the CCCTB is adopted.

3.5. Evaluation of TP risk

Several sources highlight the importance of collecting and reviewing the results of a risk management process (see e.g. p. 46 2006 EC Guide, p. 50 ff 2010 EC Guide). Such an evaluation may be done solely for internal purposes, i.e. to support the future risk management process (see e.g. NL p. 58 2006 Guide). One may also think about communicating the results externally, e.g. to other tax administrations or to the taxpayer.

For discussion:

Do you regard such a process as useful? If so, the display of the MS' results may be made by the JTPF or in an electronic form, e.g. comparable to EUROFISC or the OECD database on aggressive tax planning.

4. Organisational Factors

As a final but very important item in the area of risk management several sources stress that an organisational/administrative environment needs to be created to successfully implement a risk management strategy (p. 55 2010 Guide) on the side of both, TAs and taxpayers.

4.1. Tax administrations

Establishing enhanced relationship and the possibility of real time audits are seen as promising ways to reduce risks in transfer pricing (see presentation NL on enhanced relationships and OECD study into the role of tax intermediaries 2005 and 2008). However, the move to more cooperative approaches needs an organisational framework to make it work. Another organisational measure would be the creation of a TP panel (see p. 27 OECD Study) that e.g. will decide about which cases will finally be audited or should go to MAP/litigation.

More generally, it is regarded as important that sufficient expertise is maintained in a tax administration to face the challenges of transfer pricing (p. 60 OECD study). Some tax administrations have experience with hiring specialists for certain issues. This issue may become more important in the future, e.g. if economic valuation methods are applied in transfer pricing.

4.2. Taxpayers' side

The points addressed above with relation to tax administrations apply equally for taxpayers.

Items for discussion:

Do you have experience with respect to those organisational/administrative measures?

At the JTPF certain Members may be asked about the concrete measures they take.

What further work could be done in this respect?

ANNEX:

Glossary of terms

SOURCES

- presentations by PSM, NL, AT and UK at the October 2011 and March 2012 JTPF meetings
http://ec.europa.eu/taxation_customs/taxation/company_tax/transfer_pricing/forum/index_en.htm
- European Commission: Risk Management Guide for Tax Administrations (2006) ("2006 EC guide"):
http://ec.europa.eu/taxation_customs/resources/documents/taxation/tax_cooperation/gen_overview/risk_management_guide_for_tax_administrations_en.pdf
- European Commission: Compliance Risk Management Guide for Tax Administrations (2010) ("2010 EC Guide"):
http://ec.europa.eu/taxation_customs/resources/documents/common/publications/info_docs/taxation/risk_managt_guide_en.pdf
- OECD: Dealing Effectively with the Challenges of Transfer Pricing (2011) ("OECD Study") http://www.oecd-ilibrary.org/taxation/dealing-effectively-with-the-challenges-of-transfer-pricing_9789264169463-en
- OECD: Study into the Role of Tax Intermediaries: ("OECD Tax Intermediaries Study") www.oecd.org/dataoecd/28/34/39882938.pdf;