



BEPS TRANSFER PRICING WORKSHOP
TRANSFER PRICING DOCUMENTATION –
RISK ASSESSMENT AND SAFE HARBOURS

JEJU ISLAND - KOREA

26 – 30 OCTOBER 2015

6. Draft Handbook on Transfer Pricing Risk Assessment



What is TP Risk Assessment?



- Identify TP risk
- Determine cases for detailed audit
- Develop a **coherent and practical plan** for auditing specific transactions that pose TP risk
- Assign the **appropriate resources** to audit
- Encourage taxpayers to be **compliant and cooperative** through dialogue at an early stage



What is TP Risk Assessment?

- **Not a substitute** for audit
- Level of sophistication should be tailored to the tax administration (capacity, resources available, pool of taxpayers, stage of development in TP area)
- Judgement in selection of cases is needed
→ specialist team



Questions to be Answered

- **Materiality** : Are there material controlled transactions, also considering the size of the taxpayer and the magnitude of the transaction?
- Is there an indication of TP risk: **inappropriate shift of income** or **undue erosion of the tax base**?
- Is the case worth an audit?
- What specific issues need to be addressed during audit?



Assessing whether TP Risk exists

- (Large) recurring transactions, e.g. small pricing differences on large volume sales or purchases
- Large or complex one time transactions
- Taxpayer behaviour in governance, tax strategies or compliance



Quantifying and Evaluating the TP Risk

- What is the **tax amount at stake**?
- Risk indicators
 - Profitability: compared to
 - Industry standards or potential comparables;
 - Use of financial ratios (see next slide);
 - Related parties' or group results
 - Recurring losses, low profits or return on investment
 - Fluctuation contrary to market trends
 - Substantial or disproportionate income in low-tax jurisdictions



Transfer Pricing Methods

- Traditional transaction methods:
 - Comparable Uncontrolled Price (CUP)
 - Cost plus method
 - Resale price method

Gross profit level indicator
- Transactional profit methods:
 - Transactional Net Margin Method (TNMM)
 - Profit Split method

Net profit level indicator
- The selected method should be the “most appropriate method to the circumstances of the case”



Transfer Pricing Methodology Matrix

TP Method	Main Focus	Benchmark
Comparable Uncontrolled Price (CUP)	Product	Price
Resale Price (RP)	Function	Gross Profit Margin
Cost Plus (C+)	Function	Gross Profit Mark-Up
Transactional Net Margin (TNMM)	Function	Net Profit Margin/Mark-UP
Profit Split (PS)	Function (Contribution)	Gross/Net Profit



TNMM Method

- Examines the **net profit margin** relative to an appropriate base that a taxpayer realizes from a controlled transaction, e.g.
 - Sales
 - Costs
 - Assets
 - Berry ratio (gross profit over operating expenses)
 - Other PLI (e.g. # of employees, time, floor area, ...)
- Net margin computed **after all operating expenses** (except extraordinary items, interest and taxes)
- The TNMM must be applied in a manner consistent with resale price/cost plus method



Quantifying and Evaluating the TP Risk - Use of financial ratios

- Gross profit to net sales
- Operating profit to net sales
- Operating profit to total costs
- Operating expenses to net sales
- Gross profit to operating expense (Berry ratio)
- Operating profit to average total assets





Quantifying and Evaluating the TP Risk

- Transactions with **low-tax jurisdictions**
- **Intra-group service transactions**
- Royalties, management fees, insurance premiums, in particular paid to low tax jurisdictions (see Base Eroding Payments under BEPS Action 10)
- 'Strange' locations:
 - Marketing company located outside market country
 - Procurement company located outside country where manufacturing takes place



Quantifying and Evaluating the TP Risk

- **Excessive debt** and / or interest expense
- **Transfer or use of intangibles** between related parties
- **Cost Contribution Arrangements**
- **Business restructurings**
- Non tax factors:
 - Custom valuation, anti-dumping duties, currency exchange, price controls, ...



Indications of Low TP Risk

- Significant unrelated minority shareholders
- Transactions with jurisdictions with a higher marginal tax rate
- Similar transactions with unrelated parties under similar conditions
- Group with consistent TP policy, compliant with the arm's length principle
- Preponderance of uncontrolled transactions
- High quality information, strong compliance, high level of transparency and open engagement with tax authorities



Sources of Information

- **Taxpayer**

1. Tax return and
2. Information returns
 - Identification of
 - related parties and
 - related party transactions
 - Nature and amount of related party transactions
 - Segmented financials of transactions
 - Explanation of the differences between the financial statements and the tax return





Sources of Information

- **Contemporaneous TP documentation**
 - Overview of taxpayer and group
 - Organisation structure covering the controlled transactions
 - Taxpayer financial data, Consolidated financial data of the group
 - Functional Analysis, Selection of the TP method
 - Selection of comparables and how the comparability analysis was performed
 - Economic analysis, industry analysis and financial projections where needed
- **BEPS Action 13: New guidance on TP documentation** – Master file, Local file and Country-by-Country Report



Sources of information

- Questionnaires issued to taxpayers
- Taxpayer's files and audit records of previous years
- Publicly available information regarding the taxpayer
 - Internet
 - **Taxpayer's website**
 - Government databases
 - **Commercial databases**
 - Press reports and trade magazines
 - Securities analysts' reports



Sources of information

- **Site visits** and meetings with company personnel
- Customs data
- Patent office
- **Exchange of information under treaty**



Risk Assessment Procedure and Steps

- Assembling quantitative data from tax returns, transfer pricing forms and contemporaneous transfer pricing documentation provided by the taxpayer
- **High level identification** of possible transfer pricing risk by analysing processed quantitative data
- **High level quantification** of potential risk
- Reviewing qualitative information in contemporaneous transfer pricing documentation and gathering of additional intelligence from public sources
- Tentative decision as to whether to proceed
- More in depth risk review including analysis of functional and comparability descriptions in contemporaneous transfer pricing documentation



Risk Assessment Procedure and Steps

- More detailed quantification of potential risks
- Initial interactions with taxpayer personnel
- Preparation of draft risk assessment report
- Decision as to whether to proceed with audit, including decisions regarding issues to target in the audit
- Internal review and quality control processes, including central committee review if such a committee is used
- Prepare final risk assessment report



The Enhanced Engagement Approach

- **Aim:** to have discussions with the taxpayer about TP issues before tax return, or even before the transaction
- Some examples
 - Netherlands: **Horizontal Monitoring**
 - Significant risks are disclosed on a real time basis
 - Taxpayer submits facts and its view on tax consequences
 - Tax administration provides its views on tax consequences quickly
 - *“Certainty in exchange for transparency”*



The Enhanced Engagement Approach

- United Kingdom: **real time working procedure**

Indication on how HMRC sees the tax risk relating to a particular transaction, without inference that a particular price will automatically be considered an arm's length price.

- United States: **Compliance Assurance Programme**

Taxpayer works cooperatively with IRS in a contemporaneous, pre-filing environment to resolve issues of potential controversy and to determine the appropriate tax treatment of all events and items that could have a material effect on the taxpayer's liability. Taxpayer achieves tax certainty sooner – and with less administrative burden – than has been possible through conventional post-file examinations.



TABLE SUMMARISING RISK ASSESSMENT AND WHERE TO FIND INFORMATION

Feature	Brief Description	Where to look
Significant transactions with related parties in low tax jurisdictions	Where transactions take place with lowly taxed and related entities there is a risk that mispricing will incorrectly attribute excess profits to the lowly taxed jurisdiction.	Information return (Form) Contemporaneous transfer pricing documentation
Transfers of intangibles to related parties	Transactions of this nature raise difficult valuation questions, especially where the intangibles are unique and consequently there is a lack of comparables.	Information return (Form) Contemporaneous transfer pricing documentation Financial accounts Patent office

Feature	Brief Description	Where to look
Business restructurings	The transfer pricing aspects of business restructuring were the subject of a specific OECD study published and incorporated as a new Chapter IX of the Transfer Pricing Guidelines in July 2010.	Information return (Form) Contemporaneous transfer pricing documentation Taxpayer's website Financial accounts Press reports / trade magazines Securities analysts' reports
Specific types of payments	Payments of interest, insurance premiums and royalties to related parties because the underlying rights are highly mobile and consequently there is a risk that the payments do not reflect the true value being added by the related party.	Information return (Form) Contemporaneous transfer pricing documentation Financial accounts

Feature	Brief Description	Where to look
Loss making	Year on year loss making where there is no attempt made to change business operations or financing. Sustained losses may be evidence that the reported results do not reflect the true value of the business.	Information return (Form) Contemporaneous transfer pricing documentation Financial accounts
Poor results	Similarly results that are not consistent with industry norms or with the functions carried on by the enterprise in the country concerned may be evidence that related party transactions have not been correctly priced.	Information return (Form) Contemporaneous transfer pricing documentation Financial accounts Commercial databases Press reports / Trade magazines Securities analysts' reports

Feature	Brief Description	Where to look
Effective Tax Rate	Significant variations between the effective tax rate reported at group level and the nominal rates to which it is subject can be the result of transfer pricing that allocates too much profit to low tax jurisdictions.	Contemporaneous transfer pricing documentation Consolidated financial accounts
Poor/Non-existent Documentation	Evidence that transfer prices and the methods used to compute them are inadequately recorded casts doubt on the reliability of the prices themselves.	Contemporaneous transfer pricing documentation
Excessive Debt	Debt that appears to be in excess of the amount that an entity could borrow if it were a free standing entity, or interest rates that appear to be in excess of market rates.	Information return (Form) Contemporaneous transfer pricing documentation Financial accounts



Q & A

