

The role and design of a transfer pricing risk assessment framework for tax administrators

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Abstract: Transfer pricing has become one of the most important contemporary international tax issues. Transfer pricing risk assessment is a critical issue for all tax administrations to identify the right cases to audit and subsequently impose an appropriate level of transfer pricing enforcement in the event of non-compliance with relevant transfer pricing rules. This article will provide an overview of transfer pricing issues and examine reasons why transfer pricing risk assessments play a significant role in tax administration. Based on the approach suggested by the Organisation for Economic and Co-operation and Development, a discussion of which factors should be considered when conducting transfer pricing risk assessment will be undertaken. A number of recommendations for designing procedures and methods for the assessment will also be made for developing countries drawing from the experience of developed countries where transfer pricing risk assessment procedures have already effectively been implemented.

Introduction

Consistent with the increasing trend of globalisation and cross-border trading, the international tax systems of countries have become a significant part of tax considerations of companies because it draws “a territorial slice out of the international income pie”.¹ Transfer pricing is emerging as one of the key issues due to the growing volume of intra-group transactions, which are estimated to account for more than 30% of all international transactions.²

Tax administrations acknowledge the fundamental need to effectively manage transfer pricing and particularly utilise their limited resources to collect the largest amount of tax for the lowest possible cost. Consequently, transfer pricing risk assessments have been introduced by revenue authorities to effectively select taxpayers for audit as well as providing a method to successfully direct available enforcement resources to targeted taxpayers. By categorising taxpayers in accordance with the level of risks resulting from their transfer pricing plans, tax administrations can have greater confidence in making decisions on whether further audits should be conducted. In countries whose tax administrations have limited capacity, while transfer pricing audits are generally complex and resource intensive, the role of transfer pricing risk assessments is undoubtedly becoming more vital. It is beneficial for tax administrations to have a clear vision of transfer pricing risk assessments to be able

to assign the relevant resources in the later stages of in-depth audits to frame factual enquiries.

Though there are many concerns about the possibility of implementing transfer pricing risk assessments, especially in developing countries, it is likely their strengths positively outweigh the weaknesses. In practice, this method has proved its effectiveness in many developed countries and been supported by many international organisations such as the Organisation for Economic and Co-operation and Development (OECD), the United Nations (UN), the International Monetary Fund (IMF) and the World Bank (WB), to name a few. Depending on the available resources, this article suggests that each country should develop its own approach, although the fundamental notion of a transfer pricing assessment process is still based on the deployment of appropriate information resources to establish risk indicators in each case.

Transfer pricing context

With the rapid growth of globalisation and related developments in information and communications technologies, cross-border transactions are constantly increasing. As a consequence, worldwide production networks, in which many stages of the operation are carried out in a number of different companies in different countries, have increased. An increasing number of multinational enterprises (MNEs) have been established and have had a strong influence on the business environment around the world. These

MNEs generally operate globally and design their business structures to take comparative advantage among countries in terms of market opportunities as well as differences in legislation. The discretion to form their business models and establish internal trading conditions to benefit from these options, income, expenses, profit and the tax payable by these enterprises are allocated to ensure the most favourable tax positions although these arrangements may not reflect the true state of business nor do they necessarily correspond to the economic substance of the overall transactions.

Multinational enterprises often try to shift as much profit as possible to the most advantageous tax jurisdictions. A parent company can create an artificial price for intra-group transactions between its subsidiaries in different tax rate countries. High-price inputs and low-price outputs can be charged for subsidiaries in high tax rate countries and, subsequently, those will become high-income and low-expense in low tax rate countries, respectively.³ As a result, this arrangement can lower highly taxed income and spread lowly taxed income and consequently, the total tax payable for the MNE is effectively reduced. An example would be a company selling its products in Australia which is considered to be a high-taxing jurisdiction. The products could be provided to the Australian entity by a subsidiary based in a low-tax jurisdiction such as Singapore, Hong Kong or Malta. The product could be priced quite high to direct the profit away from Australia to the lower-tax jurisdiction.

This price may not be the price offered to arm's-length customers as it would make the supplier uncompetitive, but is imposed on the Australian-related entity to direct the profit offshore to the lower-tax jurisdiction.

Similarly, MNEs can take advantage of different tax jurisdictions by using timing rules, tax preferences or tax credits in order to manage their internal accounts and organise themselves to achieve the most effective tax outcomes. For instance, timing rule differences can be used to defer tax payments. Internal finance can be structured by way of debt provided by a related entity to subsidiaries in high tax rate countries which will subsequently incur deductible interest on a loan, rather than providing the financing as equity. The deductible interest will reduce the profit of the entity based in the high tax rate country. If the financing had been provided as equity, the profit would have remained high, as the payment of dividends is not tax deductible.

Other common techniques include those in relation to the provision of intellectual property or fees for management or consulting services between members in the same MNE.⁴ This method has been used in what has become known as the much-publicised "Double Irish Dutch sandwich". These transactions move profits from high-tax countries, such as Australia, to low or non-tax jurisdictions. The original invoice for the provision of a service to an Australian national, for example, is from a country which has favourable tax agreements with another jurisdiction. Assume that the payment is for online advertising. The payment for the sale of a product in Australia is sent to Ireland. The online advertising company then pays a royalty to an associated entity in the Netherlands. The rationale for this step is that no or low levels of withholding tax is payable on the payment of such a royalty. This payment is eventually paid through to other countries which impose no tax and as long as the funds remain offshore, no tax will be payable.

It is the use of the law in this way which limits or imposes no withholding tax which the related entities use quite legitimately to ensure that the tax paid on the original payment from Australia is as low as possible.

To avoid the misuse of transfer pricing, the arm's length principle has been introduced and used in many jurisdictions with significant support from the OECD as

illustrated in its transfer pricing guidelines. The arm's length principle suggests that income and profits arising from intra-group transactions or between related entities must be on an arm's length basis and comparable to transactions between unrelated parties.⁵ The pricing calculation generally requires a thorough procedure which takes into account economics, finance, industry norms and functional analysis.⁶ Despite its broad application, which can provide equality in tax treatments between associated and independent enterprises, it is complicated in practice. Many difficulties result from finding suitable comparisons for the intra-group transactions, especially those dealings in the integrated manufacturing of highly specialised products or intangibles, or providing specialised services.⁵ As a consequence, MNEs involved in these areas may face many obstacles in making correct transfer pricing plans in accordance with arm's length principles. In addition, as tax administrations are increasing their scrutiny of intra-group transactions, transfer pricing is one of the most critical tax risks MNEs need to accurately manage. Indeed, the uncertainty which may result from the application of the arm's length principle is putting MNEs under higher pressure of being caught in transfer pricing audits and possibly making substantial tax adjustments, as well as paying tax penalties.

On the other hand, as acknowledged in the report of Forum on Tax Administration (FTA), transfer pricing is not only a "key thing for any large multinational enterprises", but also critical for tax authorities for the reason that "they get such a significant amount of corporate tax revenue from a small number of very large enterprises".⁷ Tax administrations have experienced many difficulties in administering transfer pricing activities which are relatively in line with the complexity and development in operation of MNEs. In addition to the struggles in implementing the existing guidance of the arm's length principle, there are also many challenges in making the best use of their resources for managing transfer pricing. Tax administrations of each country have to implement an appropriate method within their limited resources to effectively tackle transfer pricing and it is extremely challenging as transfer pricing cases are "very fact and circumstance dependent".⁸

Transfer pricing risk assessment

Risk management approach

The current economic environment involves a growing trend of international trade, international mobility of capital and labour, diversification of business structures and financial industries along with the rapid development of information and communication technologies. This has provided greater access and ease for taxpayers to arrange their tax planning. It can also lead to unintended and unexpected consequences for revenue authorities by creating more difficulties and requiring greater resources for tax administrations to manage and challenge non-compliant behaviours from taxpayers. As a result, risk management is critically considered as a method which can effectively support tax administrations to allocate their existing scarce resources in a targeted and efficient way.⁹

Tax risk management consists of two main parts, including undertaking a risk assessment to obtain the risk profile of taxpayers and risk-led resource allocation.⁹ As part of the risk assessment phase, tax authorities identify, analyse and prioritise the risks from taxpayers which may prevent tax authorities from collecting the right amount of tax.⁹ After obtaining the result of risk assessment presented in the risk profile of each taxpayer, a decision will be made on which risks to be treated and the manner to allocate available resources to the areas worth paying attention to.⁹

By drawing the line between areas with high risk and those with low or negligible risk, tax administrations can more effectively respond to and challenge tax risks in general. Alternatively, taxpayers can benefit from understanding tax risk management. Taxpayers who represent high risk levels should acknowledge their potential attraction to greater scrutiny and enforcement. By contrast, taxpayers whose behaviours are assessed as transparent and are not involved in high risk issues should expect lower compliance costs. Moreover, the interaction between taxpayers and tax authorities during the risk assessment process subsequently creates certainty and trust for both sides.⁹

The reason for transfer pricing risk assessments

Transfer pricing risk assessment is the process of looking through the taxpayer's arrangement and categorising the level

of risks to the tax administration resulting from the arrangement. Subsequently, a decision is made as to whether the risk is worth pursuit by conducting a thorough audit.⁸ A transfer pricing audit is complex and resource intensive.¹⁰ It requires detailed research into the company's business with a careful review of company's documents or records and an analysis of financial information or systematic database searches. It can also require the participation of a multidisciplinary group of auditors, legal consultants, accountants, economic specialists and valuation experts. Moreover, with the objective of understanding how taxpayers generate their profit, discussions and negotiations with taxpayers are required. In practice, meetings or site visits are often carried out, which in the case of taxpayers with foreign locations can be costly and time consuming. Transfer pricing audits compel serious commitments from both tax administrations and enterprises.

Additionally, as it is practically impossible to implement audits for all cross-border transactions or arrangements between related parties, the common difficulty arising for a tax administration is how to differentiate taxpayers and transactions which engage in a high level of transfer pricing risk from those which do not. As a consequence, transfer pricing risk assessment is expected to play a fundamental role to set out the priority for the tax administration. In other words, it is considered as a structured process which is able to assist tax administrations to specify the major compliance risk of taxpayers and accurately select the cases with the most material risk.¹⁰ Moreover, as many countries acknowledge that transfer pricing is one of the significant reasons for the shortfall in their tax revenue and as many countries are under economic pressures, tax administrations need to consider improvements in managing transfer pricing in the most effective way to raise their revenue. If a transfer pricing risk assessment is well implemented, tax authorities can successfully identify transfer pricing cases with the largest potential adjustments and subsequently get "the biggest bang for their buck" in terms of audit time.¹¹ In short, transfer pricing risk assessments can help tax authorities avoid lengthy information assembling which is generally observed as costly "fishing expeditions".¹²

Furthermore, transfer pricing risk assessments support the implementation of transfer pricing audits to work more productively and use resources of tax administration, as well as those of enterprises, more effectively. Tax authorities should not carry out audits without a detailed plan in advance. If transfer pricing audits are not based on a risk assessment, cases could last much longer and key tax issues may be missed.⁸ In other words, undertaking a risk assessment will be helpful for tax administrations to arrange and develop their plans for auditing particular cases in the most practical and coherent way. With limited resources, this process can be the most effective way to appropriately allocate resources to any necessary audit commensurate with the nature and the level of risks involved.

The importance of the risk assessment process is not limited to the prior audit period and merely for the purpose of choosing the right cases to implement further audits.¹³ Risk assessment continues to benefit tax authorities throughout the auditing process when the result of a risk assessment process can be the valuable input for later stages of auditing. It also plays a supportive role in specifying additional enquiries when undertaking audits for particular transactions or arrangements. Once the risk is identified or assessed in advance, it will save time for actual audits and the effectiveness of the audit will be strengthened by appropriately only focusing on material risks.

It can also be beneficial if the taxpayer can understand the assessment process of tax administrations prior to the implementation of in-depth audits and identify all the issues which have been identified by tax authorities. In practice, many taxpayers seek to comply with tax regulations on transfer pricing and they subsequently try to arrange their transactions in accordance with the arm's length principle.¹⁰ It is not always possible for them to fully understand and effectively carry out their business in the manner accepted by tax authorities. The implementation of integrated business models and the ongoing trend of globalisation to some certain extent have caused conceptual difficulties for MNEs in applying the arm's length principle. Members of MNEs may be unsure about the method to price their intra-group transactions, although they may not intentionally try to

pursue any tax advantages or benefits. Therefore, conflicts may exist when tax administrations do not share the same perspective with taxpayers in pricing goods or services being transferred within related enterprises and other issues arising from intra-group transactions. As a result, a transparent risk assessment process can be expected to create a unified approach to risks in relation to transfer pricing and provide more certainty for taxpayers when structuring their transactions and running their businesses. Once tax administrations and taxpayers can jointly agree and be directed by the same procedure specifying how transfer pricing risks are measured, conflicts will be reduced. Taxpayers can use the understanding of the risk assessment process as a supportive guide for arranging their business with related parties. Moreover, a transparent risk assessment process can provide opportunities for taxpayers to explain any aspect of their operation which is not truly reflected or misunderstood by tax authorities.¹⁰ The process can be beneficial for taxpayers who are not selected for an audit as it allows them to better understand the process of risk measurement and allocate their resources in areas with material risks. This will increase the effectiveness of their use of their resources. Therefore, risk assessments also indirectly help taxpayers to improve the cost-effectiveness of complying with requirements relating to maintaining transfer pricing documentation.¹⁴

In contrast, lacking a systematic sharing of risk assessments can lead to frustration from MNEs who have an effective and sound system for transfer pricing, as well as from compliant taxpayers who have carried out appropriate transfer pricing plans in line with the arm's length principle. These taxpayers may experience disappointment from an inadequate transfer pricing risk assessment process.⁸ Therefore, it is essential to include risk assessments in regular and thorough transfer pricing audits as their absence may lead to an unnecessary increase in the administrative burden for taxpayers.

As stated in the draft handbook of the FTA, a transfer pricing risk assessment is designed to create an environment which is based on greater transparency and can encourage compliance with tax laws.¹⁰ This is relatively consistent with the earlier study undertaken by the OECD in relation to managing and improving tax compliance,

which initially emphasised the importance of taking a risk management approach.¹⁵ In other words, managing risk will effectively benefit tax revenue authorities by ways of constructing a systematic process of identification, assessment, ranking possibilities of risks to support decision-making in resource allocation. In an environment of limited resources, following well-structured steps of risk assessment can ensure a quick response to changing circumstances; it necessitates cooperation between taxpayers and tax administration and provides a high probability of success for tax administrations.

Process of a transfer pricing risk assessment

Given that transfer pricing is “very fact and circumstances dependent” and transfer pricing operations vary widely in many forms and at many levels of seriousness in accordance with the enforcement of transfer pricing rules, each country needs to tailor the design of its particular approach to manage transfer pricing risks. However, with the same main purpose of selecting the best cases for audits and continuing exercise during the audits, risk assessment process generally follows a common structure which involves the following steps:¹⁰

- collecting quantitative data from various resources provided by the taxpayer;
- identifying risk factors related to the case by analysing the collected quantitative data;
- reviewing qualitative information and gathering additional information from public resources;
- making a decision as to whether the case should proceed further or not;
- more in-depth review and detailed quantification of potential risks;
- communication with the taxpayer;
- drafting a risk assessment report;
- making a decision as to whether the case should proceed to an audit and if so, specifying the issues that should be targeted in the audit;
- internal review and quality control processes; and
- making final risk assessment report.

Requirement for an effective transfer pricing risk assessment

Taking into consideration many features including the number of cases, the availability of resources and the ability

to deploy the available resources, each country will need to develop its own approach to establishing an appropriate transfer pricing assessment process. Nevertheless, in general, an effective transfer pricing risk assessment should meet certain basic requirements.

First, the assessment process must be able to provide certainty for both tax administrations and taxpayers. There should be a clearly defined operation of the process in which tax authorities and taxpayers can specify the timescale, process and outcomes. Both parties should be able to estimate the workload and the management time involved, as well as the expected timeframe for completion.¹³

The requirement for detailed information collection and further negotiation with taxpayers is only undertaken when it is necessary according to the staged assessment process. The more instructive the assessment is, the more well-prepared the taxpayer’s supporting documents can be. In addition, after conducting a risk assessment, tax administrations are expected to clearly define the issues on which the in-depth audit will focus, rather than examining all the affairs of the targeted taxpayer. On the other hand, the potential consequences of the assessment must also be conveyed to, and acknowledged by, taxpayers.

Second, the assessment must ensure consistency throughout the process and provide a sufficient level of transparency.¹⁶ Taxpayers should be able to be consulted about the assessment of the tax administration on their transfer pricing plans and tax authorities should be prepared to raise their concerns and explain their reasoning for assessment of any high-risk transactions. In a similar vein, taxpayers must have opportunities to correct misunderstandings or provide further information, or can negotiate with tax administrations by engaging in open dialogue during the assessment process, rather than the tax authorities using hindsight to challenge individual assessments.¹⁷

Third, the assessment process necessitates cooperation between taxpayers and tax administrations to reduce the administrative burden on taxpayers. Once taxpayers are assessed at having a low risk of transfer pricing malpractice, even if their business are in the area of high risk, they should be accorded infrequent audits or the extent

of transfer pricing documentation required can be reduced, which subsequently reduces the compliance obligations and costs for those taxpayers. The process should be designed in such a way that the level of specification and required documentation can be adjusted in accordance with risk status.¹⁸

Furthermore, as the purpose of the transfer pricing risk assessment is to select cases worthy of being audited, a cost-benefit analysis is critical. That is, it is fundamental to compare the potential cost of resources involved in the audit and the potential expectation of additional tax revenue from taxpayers. The quantitative information selected during the risk assessment process must be sufficient to approximately reflect the possible adjustment expected to be raised from the audit. If the comparison cannot be undertaken correctly, in some certain cases, it may not be possible for tax authorities to make a decision at the end of the risk assessment process on whether or not the case is worth auditing.

In addition, as transfer pricing provisions involve cross-border transactions, this entails a greater mutual interaction between different administrations. Therefore, even if each country designs its own assessment process in accordance with its particular circumstances, it is essential to take into account the global trend of transfer pricing management. Adherence to international conventions or guidelines such as those promulgated by the OECD is not only beneficial for each separate country, but also reduces potential conflicts or debates among different tax administrations. Following a similar approach to risk assessment, MNEs are likely to experience fewer difficulties arising from distinctions among various legislations when they carry out their business across many countries.

Risk indicators

Though each country adopts its own approach to transfer risk assessment, there are some primary indicators of transfer pricing risks when transactions between related parties are arranged to allegedly shift income to low-tax jurisdictions or erode a local tax base. Nevertheless, tax administrations should bear in mind that these indicators are merely indicative of potential risks which subsequently need to be assessed in more detail, rather than assuming they automatically represent non-compliance in transfer pricing.

Transactions with related parties in a low-tax jurisdiction

Transactions with related parties in a low-tax jurisdiction may suggest a risk of mispricing and incorrect attribution of profit to low-tax countries and therefore these cases are worth looking at in more detail.¹⁰ Since MNEs might seek to take tax advantage arising from the difference in tax rates between countries and arrange their transactions to gain tax benefits, careful consideration should be undertaken to the extent of a thorough audit of arrangements with related parties in low-tax jurisdictions. Nevertheless, it is notable that the mere existence of those transactions with low-tax countries does not automatically mean they exist to exploit transfer pricing.

Favourable tax incentives or tax holiday provisions are also relevant risk factors which may attract MNEs to misprice transactions to attribute substantial profits to locations in which they are subject to these advantageous provisions. In an effort to boost the economy or attract inward investment, governments may levy lower levels of tax or offer tax exemptions or tax holidays on the profits of certain activities. As a consequence, global companies may try to take advantage of these benefits and direct profits to these countries. It is therefore essential to evaluate transactions in context with the tax policies of countries where related parties to the transaction are doing their business.

Intra-group service transactions

Issues may arise when parent companies or regional headquarters provide services for members in an MNE. It can be for administrative or general services and concerns are often raised when the payment to the parent company for intra-group services is substantially greater than the scale of the local subsidiaries.¹⁰ Greater consideration should be given when the services provided are large in scale with high value and significant to the operation of the company but are difficult to evaluate. Further investigation of the arm's length nature of the payment should therefore be based on the nature of the party providing the services, the materiality of transactions, the size of the payments and the extent to which the payment is used to erode the local tax base.¹⁰ Attention must be given to the characteristic of the benefit being provided.

Marketing or procurement companies being located outside market countries or where manufacturing is implemented

If a marketing company is located outside the country where the targeted customers are located, or the procurement company is located outside the country where manufacturing operates, there is a potential transfer pricing risk.¹⁰ This is based on the assumption that these arrangements are set up to derive income in low-tax jurisdictions other than where it would have been according to business norms, or the income accumulated exceeds that which can be justified by the economic substance of these companies.¹⁰ Thus, consideration of these activities should be part of transfer pricing risk assessment to further examine whether actual services provided are accurately reflected.

Excessive debt and interest expense

Debt that exceeds the amount which a company could borrow if it were an independent entity, or interest expenses that appear to be above the usual borrowing levels, may be an indicator of a transfer pricing risk.¹⁰ MNEs often use these methods to minimise their tax, especially when these payments are made to related parties in low-tax jurisdictions. Therefore, it is necessary to assess whether these transactions correspond to arm's length principle or statutory capitalisation rules (if any).

Particular types of payments

Similarly, where there are excessive payments of royalty, management fees or insurance premiums to related parties, which are situated in low-tax jurisdictions, or where such payments to local companies are inadequately small, transfer pricing risks are present.¹⁰ The risk involves the potential under-price or over-price to transfer income to low-tax jurisdictions by contracting in a manner which is not in line with the business substance between parties. Consideration of the company's business activities or the nature of benefit being provided between parties is necessarily taken into account and becomes part of the transfer pricing risk analysis.

Profitability

The profitability of an MNE may reflect a potential risk of transfer pricing.¹⁰ Therefore, financial results from a targeted entity should be obtained and compared to industry standards or comparable

companies.¹⁰ A large deviation may be a strong indicator of a high transfer pricing risk. Certain financial ratios such as gross profit to net sales, expenses to net sales, gross profit to operating expenses, or operating profit to total assets are calculated and compared to those average ratios from industry norms or of similar enterprises.¹⁰ Large differences between these figures could be indicators of higher risks.

The profit trend of a company which is contrary to market trends is also an indicator of risk as it represents the assumption that the company may not be receiving an appropriate share in the success of the business which may be inconsistent with arm's length conditions.¹⁰

A company which experiences continuous losses but makes no effort to improve its business operations may also attract attention as these results may not reveal the actual value of business.¹⁰ It should be acknowledged, however, that to some extent, losses over a number of years can be practically accepted with start-up companies or for the purpose of gaining market share when entering new markets or releasing new products. In these circumstances, it would be costly for companies to carry out market campaigns to penetrate into new markets and build up brands, and for a long-term purpose, they may be willing to do business at a loss initially. Nevertheless, losses are reasonably acceptable only for a certain period of time because companies should be expected to move into profit as soon as possible. Therefore, the loss or low profit over a period of many years can be a signal of a potential transfer pricing risk.

A comparison should be undertaken with related parties which are on the other side of any controlled transactions. If the combined income from the transactions is disproportionately allocated to either party, there is possibly an assumption for higher transfer pricing risk.¹⁰ This is especially the case when a large proportion of profit is allocated to a low-tax jurisdiction in which the business carried out is not major, or in which not many activities take place. As a consequence, it is advisable to look at the results of the company in the whole context of the group's performance as well as in comparison to the rest of the group. Comprehensive understanding about an MNE's income attribution among its subsidiaries can be a helpful guide to assess its overall tax planning and justify

the level of transfer pricing risk involved. It is acknowledged that there may be practical difficulties in obtaining this information or data which is necessary for the review.

Business restructuring

Business restructuring may include internal reallocation of functions, assets or risks among members of an MNE which in turn often leads to complex transfer pricing issues which need to be thoroughly investigated.¹⁰ According to the OECD transfer pricing guidelines, business restructuring may involve the transfer of valuable intangibles across borders which may cause many difficulties for tax administrations in valuing these transfers.⁸ Business restructuring may also involve the termination or substantial renegotiation of existing arrangements and this may result in internal changes in functions, assets and risks within an MNE. Rationalisation, specialisation, de-specialisation or even closing operations such as manufacturing sites, research and development activities, sales, services etc are also considered parts of a MNE's business restructuring plan. A comparability analysis of the business prior to and after the restructuring should be made to establish the rationale behind the changes. An effective transfer pricing risk assessment must be able to not only identify restructuring actions, but also examine the consequence either immediately after the restructuring or over a period of time.

Transfer of intangibles to related parties

Intangible assets, for example, trademarks, copyrights and patents, are complex to value and it is normally difficult to evaluate the cost of the development and to subsequently estimate the ultimate profit from the sale or licensing of such intangible assets. In practice, tax administrations have had difficulty in exploring the relationship between expenses and the resulting profit of intangible assets — especially of those intangible assets transferred across borders when each country adopts a different valuation method.

Intangibles are easily transferred and potentially a tool for transfer pricing because the cross-border movement of intangibles between subsidiaries of an MNE can play an important role in repositioning profits. Given the mobility of intangibles, transfer of intangibles between

related parties is increasingly becoming one of the common transfer pricing risks.¹⁰

Questions to be considered are how to decide the arm's length value of intangibles when they are transferred between companies in the same group and difficulties particularly arise from unique intangibles when there is shortage in comparable assets. It should be taken into consideration whether an intangible exists and how an intangible has been used or transferred. OECD guidelines have suggested some common indicators when a company owns valuable intangibles:¹⁰

- the company has a well-known brand for its goods or services;
- a substantial amount is spent on research and development;
- there is a routine action of sending highly qualified or skilled staff to other companies; and
- the initial nature of the business produces valuable intangibles, for example, a proprietary trading platform.

Moreover, when dealing with transactions involving intangibles, there is frequently the existence of cost contribution arrangements which potentially require transfer pricing audits to be conducted due to the long-term consequences of sharing of costs and the risks of developing, producing or acquiring intangibles between participants.¹⁰ In practice, MNEs use cost contribution arrangements to organise their process of developing or obtaining ownership of valuable intangibles. Problems often arise from the characterisation of intangibles or valuation of the contributions of participants. If a member of an MNE engages into a cost contribution arrangement with other members but the expected income stream is not appropriately corresponding to its cost contribution, there would be risks in connection with income allocation, which is not consistent with the arm's length principle and in-depth audits should be carried out.

Taxpayers' history of non-compliance

Information about the compliance status of local taxpayers or the global group to which the taxpayer belongs would be a helpful input for the transfer pricing risk assessment process. It would be reflected through the results of earlier audits in previous years or by information held by other revenue authorities elsewhere in the world.

Sources for transfer pricing risk assessments

To achieve an effective transfer pricing risk assessment, it is necessary to obtain accurate and reliable information to make decisions as to whether there are material risks present and to decide whether the case is worth pursuing to audit.

Tax returns or taxpayers' tax profile

In general, tax administrations start with a review of tax returns which represent an important source about the operation of taxpayers for tax purposes.¹⁰ This information may be able to provide tax authorities with an overall understanding of a taxpayer's business activities and also specify the requirement for specific information which is needed to be disclosed later. As discussed, profitability, or lack thereof, is one of the important indicators and would initially represent the existence of transfer pricing risks. Examining tax returns is therefore the first and most basic task of undertaking a transfer pricing assessment process.

Together with ordinary tax returns, where necessary, additional information should also be obtained through other forms or reports which represent identification of parties in intra-group transactions and which disclose the characteristics of controlled transactions.¹⁰ With the increasing operation of MNEs worldwide, quantitative information included in their returns is often in large scale. It is essential and beneficial for tax administrations to utilise computerised systems to analyse the information from the first stage of the assessment process.

In addition, information about taxpayers which is recorded and preserved in tax administration systems or results from previous audits would be helpful sources for transfer pricing risk assessments. These will provide a comprehensive picture of a taxpayer's operation and the level of compliance can be effectively reflected over a long period of time.

Contemporaneous transfer pricing documentation

A simple understanding about the identification of related parties and the nature and amount of controlled transactions between parties achieved through tax returns is not sufficient in and of itself for a comprehensive decision-making process of whether a thorough audit should be carried out. In accordance with the application of the arm's length

principle, contemporaneous transfer pricing documentation is required in many countries to provide fundamental information regarding the description of transactions and explanation of why the pricing method being used corresponds to the arm's length principle.¹⁰ From the taxpayers' point of view, it is the first chance to argue for the correctness of the transfer pricing plan. If any missing or inadequate information is discovered, it can be successively used as input for the in-depth audit at later stages.

In some countries, it may be appropriate after the review of tax returns or tax profiles instead of requiring contemporaneous transfer pricing documents for questionnaires to be sent to chosen taxpayers in order to obtain any necessary additional information.

Information from public sources

Through a number of public sources including taxpayers' websites, tax administration can find information relating to operational, organisational structure or major changes inside each MNE that may provide greater understanding about taxpayers.¹⁰ Tax authorities may seek information about the location of business activities, introduction of new products and expected sales, or relationship with other related parties etc. Such information can be a useful input to cross-check the accuracy and appropriateness of information provided by taxpayers in tax returns or contemporaneous transfer pricing documents. In practice, on the websites of some big MNEs, financial statements of previous years or prospective results may be posted which may suggest their effective tax rate.

Second, official financial or commercial information of taxpayers can be provided through commercial databases.¹⁰ These sources of information are useful for tax authorities when determining the reasonableness of pricing intra-group transactions. Potential comparables can be found and tax authorities can use information provided through these databases primarily for making comparisons between a targeted company and similar companies. It should be borne in mind that this type of information is not always available, especially in developing countries. Furthermore, in some cases, the coverage of reported companies may not accurately represent the actual trend of the market and that could thereby reduce the effectiveness of the provided information.

Another source of information which should be considered is information contained in specialised reports or trade magazines which disclose information related to targeted taxpayers or the industry they are a part of. Such information can provide tax authorities more detailed and factual knowledge about taxpayers, as well as act to corroborate data obtained from other sources.

Information from other authorities

As transfer pricing actions involve cross-border transactions, cooperation with other tax and customs authorities would be helpful in obtaining detailed information about the transfer of assets or goods between related parties from different countries.¹⁰ Customs data cannot, however, reflect the cross-border transactions of intangibles. In turn, cross-border transfers which are recorded by customs authorities do not always correspond with cross-border transactions of taxpayers due to the movement of goods within one entity without the change of ownership. Therefore, information from customs authorities is merely of supplemental or corroborative value, rather than representing the exclusive source relating to cross-border transactions for tax administrations in the transfer pricing risk assessment process.

Furthermore, with transactions that relate to intellectual property, information from patent offices would support tax authorities to recognise where there is a cross-border transaction involving intellectual property.¹⁰ Nevertheless, tax authorities should not be exclusively reliant on patent offices as there could be cases of transferring intellectual property without registration at patent offices.

Exchange of information under double tax treaties

As specified under art 26 of the OECD Model Tax Convention, it is allowable for tax administrations in two countries to exchange information about taxpayers providing there is a tax treaty between the two countries. Under the operation of tax treaties, information must be provided either automatically or according to a request. As a result, this is particularly beneficial for tax administrations in these countries when they are attempting to obtain information about associated taxpayers involved in cross-border transactions. Self-evidently, transfer pricing risk assessments require a thorough

understanding and sufficient information to effectively identify the risk indicators. Obtaining information about foreign associated parties is not a simple task and can be time-consuming. The provision of exchanging information pursuant to tax treaties between countries can simplify the process of getting access to necessary information and provide cost-saving results for tax administrations in countries which are parties to tax treaties.

Site visit and discussion with taxpayers

A meeting between tax administration and an MNE would be a useful opportunity for both sides to express their concerns.¹⁰ It is advisable that tax authorities assess taxpayers' returns and other documentations in relation to their business activities before engaging in a discussion phase. Obtaining an overall understanding and then establishing the relevant issues and information obtained from tax returns or contemporaneous documentations may not disclose all transfer pricing risks. Discussion is often the fastest and simplest way to identify the transfer pricing risks arising. Direct communication between tax administrations and people who have an in-depth understanding about the business activities and the transfer pricing plans of companies can be an efficient use of time.¹⁹

Drawbacks of transfer pricing risk assessments

As discussed, transfer pricing risk assessments provide many benefits both for tax administrations and taxpayers, however there are also a number of weaknesses that need to be recognised.

First, once a taxpayer is measured as "high-risk" under the transfer pricing assessment process, there is likely to be an "artificial" pressure for auditors in the in-depth audit stage to feel that they have to find some adjustments. This attitude arises as a balance to the cost of carrying out the audit.²⁰ However, merely being categorised as "high-risk" does not mean that taxpayers have engaged in aggressive tax planning and wrongfully carried out transfer pricing practices. In addition, risk assessments cannot be absolutely precise and successful for all cases — they are merely processes conducted to establish proper candidates for audit. As the categorisation of a taxpayer as "high-risk" may be a factor which could damage the cooperative relationship between the tax administration and the taxpayer, this process needs to be carefully managed.

Second, due to the diversification and complications in the operation of MNEs, almost all MNEs fall into the categorisation of the risk indicators listed above. Unless there is an appropriate method to accurately evaluate the possible consequences arising from the risk factors involved, the effectiveness of the transfer pricing risk assessment might not be achieved even if tax administrations can specify and allocate risk indications for each taxpayer. In practice, it is not simple for tax authorities to differentiate the more or less significant risk factors for each case. This may preclude accurate evaluation of the seriousness of the case and any consequent decision whether to carry out a further audit.

Third, large MNEs generally operate on a large scale with complex business activities which require the involvement of many parties. It is therefore impossible for tax authorities to correctly assess those MNEs without having accurate information and having a well-developed understanding of the MNEs' overall operation. However, large MNEs often hire large consulting firms to assist them in arranging their transactions and designing their transfer pricing plans. Tax administrations then may face more difficulties in assessing large MNEs. Especially with MNEs specialised in unique industries, there is an unavoidable lack of in-depth knowledge of tax inspectors. To obtain useful results after the risk assessment process for these cases, tax administrations are likely to have to commit to more cautious and limited-scope studies. Simply seeking information for risk implications is not adequate as more resources will be required to carry out a proper risk assessment. This may violate the initial purpose of the transfer pricing risk assessment of a pre-audit stage rather than engaging in in-depth audits.

Furthermore, as the effectiveness of transfer pricing risk assessment relies on the accuracy of information and the ability of tax administrations to utilise available resources and analyse collected information, there are many obstacles for tax administrations in developing countries in implementing transfer pricing risk assessments. These countries commonly lack reliable databases as well as qualified experts who have experience with transfer pricing. Therefore, there is less chance for them to reach a valid decision after the process.

Transfer pricing risk assessments in developing countries

In light of increasing concerns about transfer pricing on a global basis, developing countries have also raised their awareness of the risks resulting from transfer pricing. Together with creating a favourable economic environment to attract foreign direct investment, these countries are also in need of an effective mechanism to manage transfer pricing risks in order to get the right tax share from MNEs. Although MNEs make a fairly substantial contribution to tax revenue in developing countries, there are tendencies to shift income to low-tax jurisdictions of MNEs in developed and developing countries. Therefore, developing countries have been similarly seeking a system which can successfully govern cross-border transactions and subsequently protect against potential revenue loss from transfer pricing activities.

That said, there are many more challenges for developing countries in dealing with transfer pricing. First, difficulties normally emanate from the lack of a sufficient legal framework to regulate transfer pricing and to properly enforce non-compliance activities.²¹ Many countries do not even have adequate and comprehensive accounting provisions which meet international standards. As transfer pricing involves complex cross-border transactions, it is common that transfer pricing reports will be prepared by many legal and accounting experts. Therefore, if there is no availability of an updated administrative framework which is created in line with the common international standard in terms of accounting, economics, business etc, tax administrations can face significant challenges in implementing transfer pricing assessments.

Second, developing countries face the common difficulty in relation to identifying qualified experts who have relevant skills, knowledge and who can effectively deal with transfer pricing issues.² In fact, there is a popular trend of "drain" flowing from the tax administration area to the business environment. The scarceness of competent human resources for tax authorities, especially in the sector dealing with transfer pricing, is becoming more serious due to the favourable conditions offered by private firms. These successfully attract a great number of taxation staff leaving their jobs for larger salary payments or for a

more encouraging working environment in private enterprise. In developing countries with tight budgets, civil servants are not well paid and they often work in less favourable conditions compared to big professional consulting firms. Therefore, often tax administrations do not have a workforce with sufficient skills to carry out the necessary transfer pricing management process.

In addition, poor infrastructure with ineffective technical systems or absence of compatible IT software for tax administrations is also an obstacle for developing countries that may lead to failure in collecting relevant and complete information for transfer pricing assessment. In turn, the limited capacity of databases negatively restricts the ability to analyse available information.

The application of the arm's length principle is complex in developing countries as it is particularly difficult to find the accurate comparability due to a number of reasons. Initially, in many areas, it is not possible to create a sufficient database of comparable information. In the economies which are newly opened or only recently attracting investment, the entry into the market of "first movers" will result in little comparable information.²¹

One option such countries might pursue is requesting information from existing transfer pricing databases which have been set up based on the data collected from developed countries. However, this is generally costly and not always relevant as information is gathered from different economic backgrounds and contexts that might not be applicable to a developing country. Despite challenges like this, it is important to develop transfer pricing policies in developing economies despite the lack of experience and limited resources. This is so even though it is costly and time consuming to do so.

It can be seen as an effective choice to administer transfer pricing issues in accordance with the strategic needs and scarce availability of resources in a particular country.

The guidelines for transfer pricing and the currently issued draft handbook on transfer pricing risk assessment produced by the OECD is a useful reference for countries to effectively cope with transfer pricing. However, that process is likely beyond the capability of many developing countries to fully implement. Accordingly, developing countries need a simpler process to

identify the material risks in relation to transfer pricing. Each country will design its own assessment process depending on the factors relevant to that country. Nevertheless, the simple starting point for developing countries should involve the following steps:²¹

- identifying the size and profitability of foreign-owned corporations, including patterns of loss-making or low profits over a long period of time;
- ascertaining the identity of parties mainly dealing with large foreign corporations, including whether they are related entities;
- examining the involvement of management service fees, royalties, and interest payments between related parties; and
- analysing the domestic tax system as well as that in countries in which the main trading partners are located to detect the possible incentives for the misuse of transfer pricing.

In addition to carrying out transfer pricing risk assessments, tax administrations in developing countries should bear in mind the following tasks.

Primarily, as discussed, transfer pricing assessments fundamentally rely on information provided by taxpayers and therefore there is the critical necessity of building up reliable sources of information. It is essential to gradually build up a transfer pricing database which is necessary for an effective risk assessment process. Even OECD countries had to start modestly and formed their databases for the purpose of transfer pricing management over many years and there is inevitably a long period of time required for building reliable sources of comparable factors in developing countries.²¹ However, experience and support from developed countries as well as other international organisations, such as the OECD, the UN, the WB, the IMF etc, would be helpful for developing countries in setting up their essential databases. The multi-stakeholder Task Force on Tax and Development hosted by the OECD is paying attention to specific issues of transfer pricing, assisting developing countries to adopt more advanced approaches and meet international standards.²² Likewise, many developing countries have found from experience on database searches and contemporaneous documentation that it is a costly exercise. Such work, unfortunately, often produces too broad

a measurement of arm's length with little central tendency.²³ In addition, due to the complexity of business activities, MNEs regularly confuse tax administrations. This is by their production of sophisticated information which may often include inappropriate information. This can divert the intention of tax administrations from the correct core understanding necessary to reach relevant and precise conclusions.

The information exchange provisions under double tax agreements also represent a sound source of information for developing countries in seeking transfer pricing information. However, greater effort should be undertaken to improve the operation of information exchange as experience in developing countries has proved that the process from requesting to receiving feedback generally takes a long time and in many cases, the information received is not relevant.

Next, it is crucial to define the entity carrying out the transfer pricing risk assessment. Two models exist in organisations for transfer pricing management: centralised and decentralised models.²¹ In the centralised model, there is only a single transfer pricing unit implemented across all industries and geographical areas. The decentralised model consists of many transfer pricing units divided by industries or geography.²¹ Each model has both strengths and weaknesses. However, it is generally recommended that developing countries which are in the first stage of transfer pricing administration apply the centralised model. This is mainly due to the significance of coordination and the desirability of adopting a uniform approach at the start-up stage, along with ensuring the administration has the ability to build up knowledge quickly.

Many countries have large taxation offices, which are responsible for a wide range of issues in relation to MNEs and other large taxpayers.²¹ In view of the limited resources of developing countries, it would be an appropriate solution to utilise these available taxation office resources. Under the operation of one single unit, tax specialists, experienced auditors and transfer pricing experts can coordinate, review their knowledge, observe taxpayers' businesses and jointly make a decision on the risk assessment. By being focused on the best possible human resources, the process will more likely be able to correctly specify the

worthwhile audit cases. From that point, necessary resources can be allocated to the most material areas. Meanwhile, it is possible to design specialised teams in every region and then place members of each region on a rotation basis and exchange their experience in specifically dealing with transfer pricing.²¹ It is also advisable to involve less experienced transfer pricing specialists with more experienced specialists during the process. This would allow the transferring of skills and knowledge that subsequently results in building and growing capabilities.

There has been a suggestion that developing countries could obtain support from large accounting firms such as Big 4 companies. These are considered as good sources of information as well as being experienced in working professionally with transfer pricing issues. This may, however, not be an effective solution as in practice, these large consulting firms work closely with MNEs. They normally play a vital role in advising MNEs to arrange their transactions and prepare complex transfer pricing documentation. As a consequence, they have a primary alignment with taxpayers and may therefore not want to (or be able to) expose the information which is unfavourable for their clients as this would be a conflict of interest in their duty to their clients.

Another notable fact which should be considered is the language used in transfer pricing documentation. As transfer pricing activities are regularly spread over many countries, documents may be written in a number of foreign languages. A result of globalisation is that English has increasingly become the international common language. This requires non-English speaking countries to train their transfer pricing taxation officials to be able to use English at a high level.²⁴ In this context, risk assessments would be less time-consuming and gain greater effectiveness if the transfer pricing documents are directly assessed rather than after translation by a third party.

In addition, the continued growth of e-commerce has also created many challenges for tax administrations, especially in developing countries. The involvement of the internet has changed the form of information exchange as well as business transactions among business parties.²⁵ As a consequence, a number of problems arise from the web-based business models and cause

many difficulties for tax authorities in carrying out transfer pricing assessments. The possible solution would be learning from the experience of developed countries in managing e-commerce transactions between related parties or cross-border dealing through the internet. Initially, taxation officials should have a basic understanding of e-commerce, for example, the common e-commerce business models, the use of servers, software or how to assess the nature of e-commerce transactions.²⁵ This will not be a simple task for tax administrations in developing countries. However, the sooner the countries acknowledge and prepare for it, the greater chance they will have to adapt to the development of transfer pricing on a global scale.

Conclusion

Transfer pricing has become a critical issue both for tax administrations and taxpayers in the modern globalised economy in which they operate. The requirement for an effective method to manage transfer pricing risks is not only self-evident, but also critical to maintain the tax bases for developed and developing countries alike. The importance of transfer pricing risk assessments as the first essential stage of dealing with transfer pricing represents a pragmatic solution. It optimises the use of scarce resources of tax administrations as well as providing greater certainty for taxpayers. One of the main purposes of transfer pricing assessments is the potential reduction in documentation requirements on low-risk transactions and the requirement for customisation of transactions recognised as carrying a high level of risk.

In practice, this process has been implemented in many countries and has proved to be reasonably effective. However, countries can still improve their transfer pricing risk assessments. These activities are complex and difficult and require the building up of sufficient sources of information to overcome the lack of capacity to process and evaluate information. Many risk factors are present, however, further studies should be conducted on how to quantitatively weigh those factors and effectively make a more precise decision after the initial risk assessment process. In addition, it is fundamental to have comprehensive databases available for transfer pricing management purposes. The more detailed

the data that is available, the higher the level of acuity the analysis can reach.

Developing countries are in significant need of an effective transfer pricing risk assessment process which would help them to protect their tax base while preserving an attractive investment environment. Faced with a lack of experience in dealing with transfer pricing and limited budgets, it is critical for tax administrations in developing countries to engage in the continued building of capacity in their administrative policies, technical support systems, transfer pricing training, and the sharing of experience. Promoting internationally shared values on transfer pricing management through international organisations such as the OECD, the UN, the IMF etc or other regional platforms of administrative cooperation is vitally important as these provide for valuable inputs for transfer pricing assessments in developing countries.

Developing countries need to establish strong links with revenue authorities in more developed countries. In addition, countries at similar stages of development should initiate discussions and share economic information which could further widen the availability of comparable information.

Revenue authorities of developing countries should ensure all staff are proficient in speaking and reading English and staff should be encouraged to seek secondments to revenue authorities in different countries and to constantly improve their education levels. Such initiatives can provide important upskilling and facilitate knowledge transfers in the complicated transfer pricing area.

Finally, the staff of the revenue authorities should be appropriately remunerated to ensure that revenue authorities can attract and retain high-quality candidates.

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