

Standing up to scrutiny: Balancing the risks and rewards in transfer pricing documentation

Companies are facing a proliferation of transfer pricing documentation demands. While the new requirements set out in the OECD's Base Erosion Profit Shifting (BEPS) Action Plan will raise the bar still further, they could also provide the catalyst for the development of a more sustainable approach. So what are the key considerations for documentation policies as companies look at how to balance the need to meet tax authority expectations with curbing cost and complexity?

Globalisation is transforming the transfer pricing landscape. The rapid growth in the volume of transactions subject to transfer pricing and the countries across which supply chains stretch are creating an increasingly complex web of inter-company arrangements.

The need to create and demonstrate defensible arrangements is heightened by the intensifying spotlight on transfer pricing as cash-strapped governments look for ways to increase revenues and the taxes paid by corporations come under ever more intense media scrutiny. Some tax authorities are taking increasingly outlying positions, even if this leads to prolonged conflicts with taxpayers. Failure to resolve such disputes opens up the threat of penalties, adjustments and the risk of double taxation.

Fog of documentation

Many tax authorities are concerned that they only see the local footprint rather than the full picture of a company's supply chain. The result is a profusion of documentation demands as more and more countries introduce new or expanded disclosure requirements. The administrative headache is compounded by the fact that each country has very different rules at present. In some

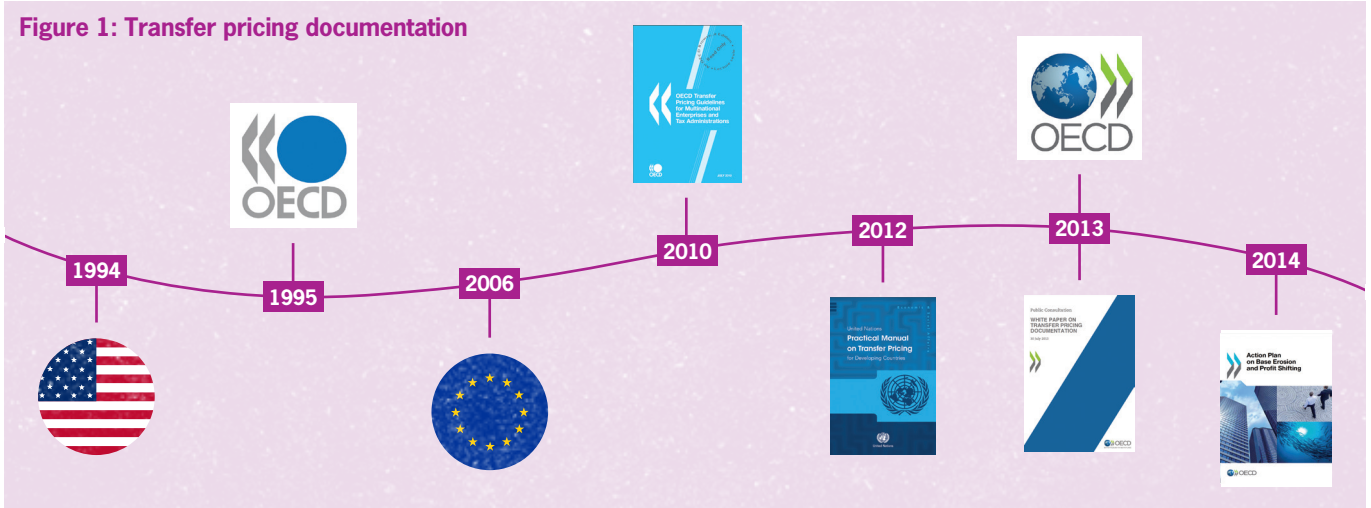
countries the focus is also reaching beyond large multinational enterprises (MNEs) to include small and medium size enterprises (SMEs).

But more detail hasn't necessarily led to greater transparency. The OECD has acknowledged that despite the significant increase in the volume of disclosure and resulting compliance costs for tax payers, the information may not be adequate for tax authorities to carry out an effective risk assessment¹.



¹ Discussion Draft on Transfer Pricing Documentation and Cbc Reporting, OECD, 30.01.14

Figure 1: Transfer pricing documentation



Evolution of international demands

So how did we get here and what are the developments ahead?

Figure 1 charts the evolution of transfer pricing requirements, which has been accelerating in recent years as the scale and focus on transfer pricing have increased.

The watchword for documentation within the OECD’s original Transfer Pricing Guidelines (1995) Chapter V was ‘reasonableness’. Rather than a prescriptive list, the guidelines simply ask for information to show that the transfer pricing is appropriate. It is very much up to each tax authority and tax payer to judge how this is interpreted, hence the wide variety in local rules.

In 2006, the EU sought to impose a greater degree of standardisation across member states. Its documentation framework is built around a master file in a common language for all member states and country files for specific countries in their specified languages. This has provided greater consistency. It is still up to tax authorities whether to apply it in the EU, and they mostly do. However, even though the framework only covers a close geographic area it has had limited success.

2010 saw a major rewrite of the OECD guidelines on the arm’s length principle, transfer pricing methods and comparability analysis. Notably, however, the documentation chapter was not covered in the update, leaving countries to add more of their own rules, which in many cases have moved further apart.

In seeking to create a clear and systematic process for evaluating transfer pricing risk, tax authorities should consider what contemporaneous documentation will be required.

The UN Transfer Pricing Manual (2012) sought to apply the OECD principles to developing markets, with the right to obtain documentation balanced against the administrative burden.

Figure 2: Documentation risk vs Reward matrix

| | Do nothing | Basic documentation | Masterfile and country file | Full documentation |
|---------------|---|--|---|---|
| Advantages | <ul style="list-style-type: none"> No cost (short-termist view?) | <ul style="list-style-type: none"> Minimal cost May be appropriate for: <ul style="list-style-type: none"> – small/med groups – small/less risky transactions | <ul style="list-style-type: none"> Mid cost Appropriate for: <ul style="list-style-type: none"> – relatively standardised groups/structures | <ul style="list-style-type: none"> Provides comprehensive documentation Minimises risk of penalties and adjustments Long term protection |
| Disadvantages | <ul style="list-style-type: none"> High risk – exposure to penalties and adjustments | <ul style="list-style-type: none"> May not comply with local documentation requirements Typically does not explain rationale for TP policies Exposure to TP audits and further info requests | <ul style="list-style-type: none"> Not acceptable everywhere May need more detail in key territories or in audit Disclosure of more general worldwide data | <ul style="list-style-type: none"> Costly Time consuming Requires significant input from finance, operations teams, local and central management |

As developments have continued to gather pace in recent years, the OECD Draft Transfer Pricing Risk Assessment Handbook (2013) sets out new guidance on the key risk factors associated with transfer pricing and how to select cases for review. It also provides an important stepping stone for the coming overhaul of documentation. In seeking to create a clear and systematic process for evaluating transfer pricing risk, tax authorities should consider what contemporaneous documentation will be required.

The 2013 Transfer Pricing Risk Assessment Handbook has paved the way for many of the proposed new rules in the OECD’s White Paper on Transfer Pricing Documentation – the foundation for a new Chapter V. The new guidelines seek to ensure that documentation provides a genuinely informed basis for risk assessment by bringing documentation up to date with today’s more globalised marketplace, creating a more consistent international approach and striking a better balance between transparency and the burden of proof.

Documentation is seen as an anchor for best practice, assisting tax authorities with their risk assessment and providing information for a potential tax audit. The discipline of a more documented approach is also seen as leading to more robust policies and reducing risk within companies themselves (“mindful compliance”).

The new standardised requirements would be based on a two-tier master file and local file set of templates, echoing the EU framework. In a much more prescriptive approach than the current Chapter V, MNEs will be required to disclose key business and financial information using a bottom up entity-by-entity basis of preparation. Compliance issues include the higher focus on contemporaneous information and update of comparable financials annually, with a full re-run of benchmarking on a three year cycle. There is likely to be a lot more focus on the ‘significant people functions’ (i.e. the people carrying out and overseeing key activities).

The proposals are given added impetus by being one of the first stages of the BEPS Action Plan, a much wider review of transfer pricing policy and oversight being ushered by the OECD under the auspices of the G20. Enhancing transparency and standardisation is seen as a crucial bulwark in the OECD’s drive to eliminate the gaps and mismatches in tax rules that it believes can allow profits to disappear or enable profits to be diverted to jurisdictions where there is little relevant activity. In short, the focus on documentation isn’t just a paper exercise, but a key part of the international community’s determination to close up tax loopholes.

How much is enough?

As with any decision over how to approach transfer pricing, companies will need to weigh up the potentially competing considerations of cost, risk, certainty and tax optimisation. Figure 2 provides a matrix for assessing the advantages and disadvantages of more or less documentation.

Businesses choosing to do the minimum increase the risk of investigation and sanctions, which could prove more costly in the long run. Basic documentation may be sufficient for companies with relatively few and generally straightforward transactions. Further work will be needed if the group's affairs are complex or the company is subject to a tax authority audit

At the other end of the spectrum, full documentation minimises the risk of adjustment and audit and would enable companies to operate with more assured tax policies and projections over the long-term. This could be especially important for companies with a large volume of complex transactions, which are likely to be in the tax authorities' sights. But the costs could be significant. Greater transparency would also have to be weighed up against issues of confidentiality. Many companies are concerned about how the information disclosed in the master files and annexed country-by-country reports will be used and shared by tax authorities. Moreover, despite greater standardisation as a result of the new Chapter V, interpretation may vary and many national tax authorities are likely to continue to insist on additional requirements.

Plan, implement, defend

While there is no one size fits all solution, we believe that a 'plan, implement and defend' approach that builds documentation into the wider risk management of tax and transfer pricing should enable companies to keep tax authorities on side without over-burdening the business (see Figure 3).

Figure 3: Transfer pricing framework



Transfer pricing policies should fully reflect the business model, have a justifiable rationale and be applicable at a local level. As companies look to create a defensible approach, many are seeking to reduce the risk of disputes by negotiating Advanced Pricing Agreements with single or multiple tax authorities.

Effective documentation can help to reassure authorities that policies are robust and being enforced. This in turn requires a clear view of the most material risks that authorities will be focusing on and how to ensure the justification and transparency that will be needed to reassure them. Arguably, all inter-country transactions have some element of risk. In practice, authorities will be looking most closely at higher risk transactions, such as those involving licensing arrangements, transactions with real or perceived 'tax haven' locations or those where there are persistent losses. They will also be targeting companies and transactions where there is no clear or consistent policy on how prices are apportioned.

An effective documentation framework binds the high level strategy and risk identification with application on the ground (see Figure 4). Documentation should explain the policies in force and their rationale, focusing most closely on the higher risk areas. It should also demonstrate the consistency of the policies and underlying accounting procedures being applied. Key sense checks include whether the documentation reflects the value chain of transactions and the strategies that drive this and, if not, whether transfer pricing is influencing this.

Practical application

The first step is to ask people who are managing the activities to review the transfer pricing rationale and risk of each transaction. It is then important to check whether policies are consistent and being applied uniformly, as well as monitoring any changes in conditions. Data is clearly going to be a huge challenge. But a systematic assessment of what is material will help to make sure the resources needed for data extraction and management are efficiently focused.

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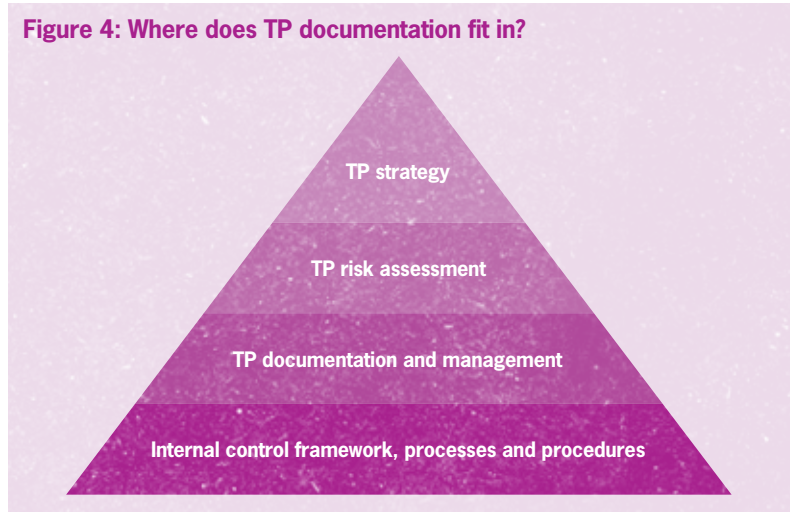
Specific local requirements will remain. But, the greater standardisation under the new country files can provide a foundation that can be adapted to local needs. Some tax authorities impose additional demands on tax payers and it will therefore be important to think about these jurisdictions in the evaluation and preparation of documentation. Factors to be considered include annual requirements (eg India), countries outside the OECD framework outlying policies (eg Brazil) and accelerated timelines for disclosure (eg Poland).

Geared up for change

The consultations beginning in May 2014 will pave the way for a finalised set of Chapter V documentation requirements. It will be important to assess the impact on the business both directly and as part of the wider changes being developed under the BEPS Action Plan.

There is no one-size-fits-all approach. The areas to be weighed up include cost versus tax authority assurance and transparency versus confidentiality. In all cases, building documentation into a proactive and systematic approach to transfer pricing will help to minimise the potential for disputes, while curbing any unnecessary demands on the business.

Figure 4: Where does TP documentation fit in?



Simply ignoring these developments or taking a reactive approach will heighten the risk of being targeted by tax authorities. It will also make it much harder to deal with audits and to contest potential sanctions.

In short, documentation can be a burden, but it is also your best defence.

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