

Chapter 8

Audits and Risk Assessment

8.1. Introduction to Audits and Risk Assessment

8.1.1. As discussed in Chapter 1, establishment of an appropriate “arm’s length” result is not an exact science and requires judgment, based on sound knowledge, experience and skill. Owing to the complexities inherent in transfer pricing, a transfer pricing enquiry is usually complicated and can become a costly exercise both for a revenue authority and a taxpayer. It should therefore not be undertaken lightly; due consideration should be given to the possible complexities and to the amount of tax at risk.

8.1.2. The outcome of an effective audit process is two-fold:

- (i) increased future compliance (which indirectly contributes to future tax revenue and protection of the tax base) and
- (ii) increased current tax revenues (where cases are successfully audited).

8.1.3. Transfer pricing audits are generally time and resource intensive, while any increase of “current” tax revenues resulting from such audits may refer to revenues that would be collected in a year or two. The hard work involved in a transfer pricing audit may result in significant revenue adjustments that can be used for development of the country; however, such results do not come quickly and easily – considerable resilience is required due to the complexity and uncertainty inherent in transfer pricing issues. Transfer pricing units in both the tax administration and corporate consulting often come under significant scrutiny as the returns from expensive transfer pricing resources do not seem to come immediately or often.

8.1.4. The better the “quality” of the cases referred for audit, the higher the probability of successful audits and vice versa. It is therefore just as important to dedicate adequate time and resources to risk assessment as it is to dedicate the appropriate time and resources to the audit of a case. There are various factors that could be used to “flag” higher risk transactions and these will be discussed in more detail below.

8.1.5. Materiality, used in isolation, is not generally a reliable basis for risk assessment, as transactions are often over or under valued due by transfer pricing. Accordingly, where materiality is used as the primary basis for case selection, an undervalued transaction may be

overlooked due as it appears to be immaterial. This could be a direct result of the entities charging non-arm's length prices.

8.1.6. It is advisable to separate the risk assessment process for transfer pricing and thin capitalisation purposes (depending on domestic legislation). Thin capitalisation is generally easier to detect (particularly where a debt : equity safe harbour is in place as is the case in most countries) and the auditing process may be shorter. Transfer pricing audits generally take much longer to resolve and are usually more complex.

8.1.7. Risk assessment should be carried out at various stages of the audit subsequent to the initial risk assessment, similar to a cost/benefit analysis, to ensure the most efficient and effective use of time and resources. This should be built into the auditing process and incorporated in an audit programme.

8.2. Organization and Staffing of Transfer Pricing Audits

8.2.1. Administrative Aspects

8.2.1.1. Tax administrations vary in terms of how their respective transfer pricing units are set up. The spectrum of transfer pricing work undertaken, policy regulations, geographic size, level and complexity of transfer pricing activity, quantum of the tax base, number of resources etc. may impact on how the transfer pricing division is structured within the tax administration. the following functions are likely to exist in most developed countries:

- audit section – transfer pricing risk assessment¹ and audits
- specialist advisory function – provision of technical guidance on audits, dispute resolution (settlements) and negotiation of APAs etc.
- Competent Authority – Mutual Agreement Proceedings and possibly APA's
- Advance Pricing Agreements

In contrast, developing countries may undertake only some of the aforementioned functions depending on their stage of transfer pricing advancement and development. For example, some

In some instances the risk assessment capability may be a separate unit outside of the audit section.

^{1 2} DSG Retail and others v HMRC [2009] STC (SCD) 397

countries do not have an APA program or an established transfer pricing Competent Authority section.

8.2.1.2. Generally, two types of structural models exist; centralized and decentralized. See further chapter 4, paragraph 5.1., et. seq.

8.2.1.3. One variation that may be considered is the establishment of specialist transfer pricing capabilities separated into functional units i.e. risk assessment, audit, MAP, APA teams. There may be overlaps in the use of expertise and resources but to a large degree each functional unit will be individually staffed. An alternative approach within the decentralized model involves creating a specialist function at the centre of the tax administration to advise generalist auditors and tax inspectors on how best to conduct transfer pricing audits through the provision of technical support. It is rare for these specialists to conduct audits themselves but that can happen when issues are particularly complex or contentious. See further chapter 4, paragraph 5.9.

8.2.1.4. Both models can be applied at a national or regional level, are interchangeable and contain associated advantages and disadvantages. There is no established best practice and tax administrations should combine the models to suit their own environment. It may be advisable for developing countries to adopt a centralized model at the inception or during the infancy of the transfer pricing administration. This will enhance development of experience and capability, consistency and quality in audit approach and establishment of best practice. See Chapter 4, para 5.1. et. seq. for further analysis of the centralised and decentralised models.

8.2.2. Staffing and Resourcing

8.2.2.1. Transfer pricing is not an exact science and requires judgement and discretion; audits are often complex and time and fact intensive. Owing to this, it is critical that adequate resourcing is available for transfer pricing audits. Developing countries are generally more constrained in transfer pricing resources, and a tax administration can be challenged by the complexity and volume of audits. The matching of adequate and appropriate skills and resources to a transfer pricing audit is critical to the efficient, timely and successful conclusion and even resolution of an audit.

8.2.2.2. The challenge most developing countries face is the ability to employ, develop and retain these resources. In this regard, developing countries need to be innovative and

strategic. Implementation of targeted recruitment and structured training programmes will assist developing countries in attracting, developing and retaining transfer pricing skills. Training and development including challenge and variety in work scope within the public sector is also often a draw card and tax administrations in developing countries need to leverage off all that this can offer to attract and retain transfer pricing resources. See further Chapter 4, para 6.1. et. seq.

8.2.2.3. Most tax administrations employ a variety of skills within the transfer pricing unit. These range from economists, lawyers, accountants, industry experts and generalists. Over time these resources are developed into transfer pricing specialists. Where there are insufficient transfer pricing resources it is critical that any transfer pricing audit be staffed with at least one transfer pricing specialist.

8.2.2.4. It is neither practical nor good governance for a transfer pricing audit to be conducted by a single auditor (be it a specialist transfer pricing auditor or another tax auditor). Transfer pricing audits are generally conducted by teams of two or more persons with varying degrees of input from other team members. In most developed countries it is customary for every transfer pricing audit team to include an economist. In other countries, the role of an experienced transfer pricing specialist is a must especially if the audit is done in partnership with the generalist audit section. This “mixed teaming” approach allows transfer pricing risk to be audited alongside other tax risks; it also allows greater flexibility in resource deployment and the sharing of complementary skills and experience.

8.2.2.5. Another approach adopted within centralized specialist transfer pricing teams is the partnering of less experienced transfer pricing specialists with more senior and experienced specialists. This allows for transfer of skills and knowledge sharing and is an effective way of building and growing capabilities.

8.2.2.6. Developing countries with transfer pricing resource constraints may consider the use of external consultants and experts. There are instances where some countries have made use of external economists and counsel to provide technical opinions on transfer pricing audits. Whilst not the preferred approach, given the potential costs involved, it can be a short term solution.

8.2.2.7. Developing countries may want to explore the option of staff exchange with developed countries as a way of building capability and capacity. This could be a useful mechanism for developing countries to expand their transfer pricing capabilities as seconded staff could be

utilized to train and develop transfer pricing resources and provide input into audits. See further Chapter 4, para 8.1.4.

8.2.2.8. Various non-governmental organizations (NGOs) and international organizations such as the African Tax Administration Forum (ATAF) and the OECD run training and advisory outreach programmes in the area of transfer pricing. These programs are vast and varied in content but are essentially aimed at bringing international expertise and best practice to countries in need of developing and furthering their transfer pricing regimes. See Appendix III for a list of available training resources.

8.3. Selection of Taxpayers for Transfer Pricing Examination – Risk Assessment

8.3.1. Overview

8.3.1.1. Effective risk identification and assessment are important steps to ensuring that the most appropriate cases are selected for audit. Given the resource constraints it is important for any tax administration that material high risk transfer pricing cases do not slip through the tax net. However, even the most robust risk identification and assessment tools and processes may not always guarantee success in audit. The reason for this is that the level of detail available at the risk assessment stage may not always be sufficient to draw reliable conclusions regarding the arm's length nature of profits/prices. This will depend on functional classification (based on the risks assumed, functions performed and risks borne by each party), the methods applied, allocation keys selected and so forth.

8.3.1.2. There are several ways in which a tax administration may conduct its risk identification and assessment, and is largely dependent upon the type of information and data that is available and accessible. For example, in some countries exchange control authorities may work hand in hand with the tax administration and sharing of information is strong whilst in other countries such interaction may be prohibited. Some countries have strong filing and documentation requirements designed to ensure that relevant and appropriate information is submitted. This is very useful in risk identification and assessment, as the availability of all such relevant information can enhance the quality of the risk identification and assessment process.

8.3.1.3. It is important to draw a distinction here between information related to filing a tax return and transfer pricing documentation. This may vary from country to country but in essence is as follows:

- Filing information typically relates to questions on a tax return. This may entail a tick the box (i.e. yes or no) or fill in the box response (e.g. inserting a quantum or value).
- Documentation, in the context of transfer pricing, will generally include more substantial information such as a Transfer Pricing Policy Document, legal contracts, invoices, valuations etc. Regulations governing documentation differ from country to country in that the retention of documentation may be obligatory or voluntary. Some countries may mandate the type of documentation a taxpayer has to prepare whereas other jurisdictions merely make a recommendation. In some countries it is not possible to submit documentation when filing a tax return and this may need to be specifically requested during a transfer pricing audit or filed separately.

8.3.1.4. A tax administration should ensure a balance between the cost of compliance for taxpayers and its own information needs. This is increasingly difficult given that transactions are becoming increasingly complex in nature. See Chapter 7 for a more in-depth analysis of transfer pricing documentation.

8.3.1.5. A risk identification and assessment process followed by engagement with the taxpayer can at times be a worthwhile approach for tax administrations to adopt. This allows for better understanding of the risks identified and gives taxpayers the opportunity to explain the commercial context of the transactions/risks identified. Such an approach is again designed to ensure that the risks have been profiled in the most robust manner before resources are committed to carrying out an in-depth audit.

8.3.2. Categories of Risk

8.3.2.1. Transfer pricing risks arise through intra group transactions e.g. payments for goods, services and intangible property, provision of financial assistance etc. Such transactions or categories are often readily identifiable on the Income Statement and/or tax return.

8.3.2.2. It may be useful to try to classify the transfer pricing risks into categories in order to give added value and context to the risk identification and assessment process. Such categorization can assist risk profilers/assessors to evaluate the aggressiveness and complexity of the risk, the possible quantum at stake and the probability of success (i.e. the likelihood of an adjustment, the level and number of resources that may be required, etc). Such classification can assist in determining whether a case is worth pursuing (now or later) and whether or not the requisite resources and expertise are available.

8.3.2.3. The following describes some of the more complex categories of risk that are not always readily identifiable. It is by no means exhaustive and it is acknowledged that additional classes and categories of risk may exist:

1. Intentional profit shifting through new structures;
2. Intentional profit shifting through restructuring;
3. Intentional profit shifting through incorrect functional classification, the use of incorrect methods, allocation keys, etc.
4. Thin capitalisation; and
5. Unintentional profit shifting.

8.3.2.4. The risk classification provided here as an example assists the risk profiler/assessor in the evaluation of each of the following in respect of potential cases:

- The likelihood of detection by revenue authorities;
- The possible value of the profit shifting (and therefore the potential value of the risk); and
- The amount of time and resources required to audit the risk (including the level of expertise required from those resources).

8.3.2.5. Category 1 (“Intentional profit shifting through structures”) includes new structures implemented by multinationals with the intention of saving taxes by shifting profits. It is assumed that the potential tax savings for groups implementing these types of structure may be significant and the tax risk is therefore assumed to be high. It is however difficult to detect these structures through general risk identification and assessment process as such structures are often not disclosed. The likelihood of detection is therefore often low. In such instances a tax administration’s awareness of possible tax planning schemes and structures (for example, through its disclosure and filing requirements) and its own analysis of potential loopholes in the tax system may trigger further investigation. This is however time and resource intensive, requiring experienced staff.

8.3.2.6. Category 2 (“Intentional profit shifting through restructuring”) is distinguished from the Category 1 by the fact that a tax saving/profit shifting structure is implemented at a certain point in time, resulting in a change to an existing structure or business model. Accordingly, this is referred to as a “restructuring”. The risks associated with a restructuring are different for the various jurisdictions affected. The country where the MNE is headquartered (and possibly where the intangibles were originally developed and/or owned) would face different risks from those faced by a country where the MNE has a subsidiary doing manufacturing,

distribution or marketing. Restructurings are not readily detectable but can be identified through static profit margins (where a subsidiary has been restructured from a full risk distributor to a limited risk distributor) or through changes in VAT returns etc.

8.3.2.7. In this situation, (Category 2) the jurisdiction where the MNE is headquartered would face issues revolving around the valuation of externalized intangibles, deemed disposals of assets for capital gains tax purposes, etc. In addition the headquarter jurisdiction may have to deal with the classification and benchmarking of profits for the “principal/entrepreneurial” entity remaining or created as a result of the restructuring.

8.3.2.8. On the other hand the subsidiary jurisdiction/s in Category 2 would mainly be concerned about risk stripping and profit loss. The primary concern in this regard is that an entity has been stripped of its risks and responsibilities on paper (i.e. contractually), but it continues in practice to carry out the same functions or assume the same risks economically. The entity is effectively being paid less for doing the same things it was doing prior to the restructuring.

8.3.2.9. In Category 3 (Intentional profit shifting through incorrect functional classification, the use of incorrect methods, allocation keys, etc.) MNEs may intentionally shift profits through the misclassification of entities, the application of incorrect pricing policies or unsuitable allocation keys. For example an entity may, during a period of economic upturn, be classified as a limited risk distributor and be rewarded with a fixed (but relatively low) gross margin, when it is in reality fulfilling the role of a fully fledged marketer/distributor and should be sharing in the economic profits earned by the MNE as a whole. In another case, a MNE could be allocating service charges based on a percentage of turnover as opposed to the actual services performed thereby extracting profits through excessive service charges.

8.3.2.10. It would be a challenge for a revenue authority to detect the types of intentional profit shifting activity by an MNE in Category 3. It would for instance require an evaluation of profit margins over an extended period of time against market/industry trends, an in-depth functional analysis of the entities that are party to the transactions and a detailed understanding of the pricing policies. Accordingly, the likelihood of detection at the time of risk assessment with the limited information available would be moderate to low. On the other hand the values at risk may be moderate to high (as a result of the intentional profit shifting that has occurred), but would in all probability require the involvement of experienced resources for an extended period of time to increase the likelihood of a successful audit.

8.3.2.11. Category 4 (Thin capitalisation) includes both intentional and unintentional profit shifting by MNEs through debt. In most countries, thin capitalization is regulated through safe harbours set at predetermined levels of debt to equity. Where this is the case, the likelihood for risk profilers/assessors of spotting such abuse is high, as these calculations can be easily performed or even automated to flag thinly capitalized entities. Even in cases where countries do not have safe harbours, they can set parameters or thresholds for risk assessment purposes. The local laws and regulations will accordingly influence the level and amount of resources required to audit these cases. The values can range from very low to very high, but their quantification should be simple (in cases where safe harbours or risk assessment thresholds exist). This should be an area of focus for developing countries with simple thin capitalization rules as it could be considered “low hanging fruit”.

8.3.2.12. Category 5 (Unintentional profit shifting) results from cases where taxpayers get their transfer pricing wrong or the revenue authority disagrees with the pricing policies applied whether it be the functional classification, methods applied, etc. Where this occurs it is likely that the values could be material, but they would be less significant than in cases where a MNE is actively implementing a profit shifting scheme. The level and quantum of resources required to audit the case would depend on the nature and extent of the perceived transgression by the taxpayer, as would the likelihood of detection by the revenue authorities.

8.3.2.13. The descriptions of the risk categories explained above are summarised on a simple matrix below. The likelihood of detection and the potential value of the risk is represented by the two axes and categorized as high, moderate or low. The size of the bubble indicates the amount of time and resources required – the bigger the bubble, the higher the time/resource intensity of the audit likely to result.

		Likelihood of Detection		
		LOW	MODERATE	HIGH
V a l u e	HIGH	1	2	
	MODERATE		3	4
	LOW		5	

8.3.2.14. Where transactions seem to fall the above categories, it is also useful to evaluate the risks as classified and explained above, within the context of whether the risk is associated with an inbound transaction/MNE or outbound transaction/MNE. An inbound MNE is an MNE which is headquartered elsewhere but has a subsidiary in the country where the risk assessment is being undertaken. An outbound MNE would be the opposite i.e. a group headquartered in the country where the risk assessment is being carried out with operations elsewhere in the world.

8.3.2.15. An inbound transaction is a transaction where the goods or services are flowing into the country where the risk assessment is being conducted; and vice versa for an outbound transaction. It is worth noting that an outbound MNE may have inbound transactions. When evaluating the outbound MNE, certain flags would be triggered whereas the evaluation of the inbound transactions undertaken by the outbound MNE would trigger other risk issues. These are summarised in the table below:

TYPE	INBOUND TRANSACTIONS/GROUPS	OUTBOUND TRANSACTIONS/GROUPS
Funding	Thin Capitalisation	Interest Free loans
Interest rates	Excessive interest rates	Too low interest rates
Goods	<ul style="list-style-type: none"> Offshore procurement/sourcing companies to keep profits offshore General mispricing (intentional /unintentional) 	<ul style="list-style-type: none"> Offshore marketing companies to keep profits offshore General mispricing (intentional/unintentional)
Services	<ul style="list-style-type: none"> Excessive fees relative to benefit provided Charging when no service received Duplication/Shareholder services 	<ul style="list-style-type: none"> No charge at all Too low fees relative to benefit provided
Intangibles/IP	<ul style="list-style-type: none"> Excessive charges Duplicating charges through royalties over and above inflated prices 	<ul style="list-style-type: none"> Not charging for intangibles developed locally Externalising IP without reward
Structures	<ul style="list-style-type: none"> Restructuring New structures 	<ul style="list-style-type: none"> Restructuring New Structures To avoid/minimise imputation through CFC rules Use of offshore branches in low tax jurisdictions with DTAs

*Outbound Groups – Parent Company is located onshore

*Inbound Groups – Parent Company located offshore

8.3.3. Types of approach

8.3.3.1. There are various approaches that one could take in order to identify companies/groups with transfer pricing risks. These include:

- a. The transactional approach;
- b. The jurisdictional approach; and
- c. The risk based approach.

8.3.3.2. Transactional approach: In order to get going or build capacity and expertise through “on-the-job” training it may be useful to adopt a transactional approach in terms of which simpler transactions, which may be easier to price, are audited first. These include for example interest-free loans and thin capitalisation. These are more easily identifiable but not necessarily easier to audit in all circumstances. For example, due to access to information restrictions some jurisdictions may face greater difficulty in auditing service transactions whereas another jurisdiction may be able to audit these transactions with relative ease. Alternatively the focus could be on higher risk transactions with a higher possible revenue yield, such as business restructurings, etc. Finally, examination of a combination of more

complex and simpler transactions can be adopted in order to ensure a more consistent flow of work and revenue.

8.3.3.3. Jurisdictional approach: A revenue authority may adopt an approach under which transactions entered into with entities in identified tax jurisdictions are prioritised for audit. A crucial element of this approach is the inclusion of both direct and indirect transactions entered into with such jurisdictions, e.g. schemes or structures ultimately benefitting or involving entities in these identified jurisdictions. This will require the transfer pricing unit to identify those jurisdictions it considers to be of higher risk within the context of domestic tax rates, domestic trade flows and domestic economic policies. It may be that higher rate tax jurisdictions are flagged for prioritisation where those jurisdictions are perceived by MNEs to have particularly aggressive transfer pricing rules or practices. MNEs may apply transfer pricing in such a way that it favours the more aggressive jurisdiction (in order to avoid potential audits in these jurisdictions) at the cost of the jurisdiction where transfer pricing is not as aggressively pursued. In adopting this approach, care should be taken not to fall foul of international anti-discrimination rules.

8.3.3.4. Risk based approach: This is in essence a hybrid of the first two approaches, but could also consider factors other than the jurisdiction of the related party/ies and the type of transactions. Other factors of interest would for instance include:

- The tax compliance status of the local entity or the multi-national group to which the entity belongs (i.e. how compliant is the company/group generally or specifically to transfer pricing in your country or elsewhere in the world). Where groups/entities have been successfully investigated by other revenue authorities this could provide an indication that the group presents a higher risk for transfer pricing purposes.
- A group that has recently undergone a business restructuring, particularly where the local entity has been “stripped” of certain risks and/or functions as part of the restructuring.
- Companies with excessive and/or continued accounting/tax losses relative to a profitable group outside your country.

8.3.4. Sources of information for risk assessment

8.3.4.1. Tax returns: Tax authorities should work as far as possible with the information provided by the taxpayer. The tax return should ultimately aim to obligate taxpayers to

include the information that would be most useful for the tax authority to utilise for effective risk assessment. The use of quantitative rather than qualitative data will assist in the automation of risk assessment tools. Examples of useful information on transactions include the value of the following transactions of any cross-border related party:

- sales;
- purchases;
- loans, including interest received and/or accrued;
- royalty payments;
- service fees;
- derivatives transactions;
- debt factoring or securitisation transactions; or
- share remuneration transactions.

8.3.4.2. Publicly available data: This includes for example newspapers, websites, databases and publications such as “Who owns Whom” or databases of company financial information. Unfortunately databases and publications in this area can be expensive, and developing countries may often have to be more reliant than their colleagues in developed countries on information provided by taxpayers.

8.3.4.3. Court case judgments: Published judgements of cases heard in other countries may contain useful intelligence regarding a group’s activities, transactions and pricing policies. These could also provide useful guidance on structures/schemes implemented in certain industries. The analyses of such decisions provided by law and accountancy firms to their clients, such as the analyses of the Dixons case² in the UK are often freely available and can also be helpful in identifying similar issues in your jurisdiction. Access to transfer pricing information databases such as those of BNA or IBFD can also be useful, if the cost of at least one licence can be organised through the administration budget or donor support.

8.3.4.4. Financial Statements: Particular attention should be paid to notes to the financial statements on related party transactions and loans/financial assistance.

8.3.4.5. Customs Data: In some instances customs data may be relevant to obtaining information on intra group transactions. It is sometimes the case that the import price may be an indicator of the true transfer price.

8.3.5. Risk factors/risk flags: Certain “flags” can point to the need for further examination.

They should not be treated as decisive in determining that non arm’s length pricing has occurred, of course – at most they point to a higher than normal likelihood of such mis-pricing.

See Chapter 4 for additional indicators of risk; commonly agreed risk indicators include:

- Consistent and continued losses;
- Transactions with related parties in countries with lower effective/marginal tax rates, especially secrecy jurisdictions;
- Local low profit or loss making companies with material cross-border transactions with related parties offshore, where the offshore part of the group is relatively much more profitable;
- The existence of centralised supply chain companies in favourable tax jurisdictions i.e. centralised sourcing or marketing companies located in jurisdictions with low or no tax regimes and which are not located in the same country/region as the group’s main customers and/or suppliers.
- Material commercial relationships with related parties in jurisdictions with aggressive/strict transfer pricing rules – the corporate group may be more likely to set transfer prices in favour of the more aggressive jurisdiction at the cost of the less aggressive jurisdiction, due to the higher likelihood of intense scrutiny in the first jurisdiction.
- The same applies in the case of material commercial relationships with companies located in the “home” jurisdiction of the MNE or the location where the holding company is listed.
- Similar considerations apply where there are material commercial relationships with companies in jurisdictions that employ safe harbours or similar rules that do not always align to the arm’s length principle.

8.3.6. The Risk Assessment Process

8.3.6.1. As stated, the risk identification and assessment process may vary from one tax administration to another depending on the approach taken, the resource capability, the state of play etc. Some tax administrations have very sophisticated processes employing computerised systems etc. whilst others may adopt a more simplified process. Ultimately the risk identification and assessment process will depend on what a tax administration has at its disposal in terms of information, capability and systems or technology. It can however be said that the more refined and sophisticated the risk identification and assessment process the easier it will be to ensure that material high risk transactions are identified and audited.

8.3.6.2. The basic steps of the risk assessment process can be described as follows:

- Initial review and identification of the possible risks;
- High-level quantification of the possible risks;
- Gathering of other intelligence;
- Decision as to whether to proceed;
- More in-depth risk review including high-level review of documentation and functional analysis to confirm initial findings;
- More detailed quantification of possible risks;
- Initial interactions with taxpayer; and
- Decision as to whether to proceed to audit by way of specialist reviews or committee based/panel reviews.

8.3.7. Risk Assessment Tools

8.3.7.1. Some of the more common risk identification and assessment tools include calculation templates for thin capitalisation and templates for calculating key ratios. Such tools are rudimentary based on quantitative information readily available to non-transfer pricing auditors. This may include e.g. information available from the tax returns and audited financial statements to assist auditors in flagging those cases with probable transfer pricing/thin capitalisation risks.

8.3.7.2. Where specialist transfer pricing capability and resources are limited, generalist auditors may be deployed to assist with risk identification and assessment. In such cases these basic tools ideally do not require non-transfer pricing skilled auditors to apply their discretion or have any transfer pricing/thin capitalisation knowledge. They merely require the auditors to input certain data, run the calculations (if not automated) and report the results (where above or below certain pre-established thresholds) to the transfer pricing unit. The decision as to whether to involve the auditor going forward is then a decision that should be made on a case-by-case basis by those with special transfer pricing expertise as part of the audit process.

8.3.7.3. Basic quantitative risk assessment tools are particularly effective in the identification of thin capitalisation risks as this usually involves a quantitative test of the financial data and is in most cases, depending on the local legislation, a matter of fact rather than opinion. Automated risk assessment tools that can be used to run through large sets of available data can be used very effectively in this area.

8.3.8. Risk assessment findings

8.3.8.1. It is important that the outcomes of a risk identification and assessment process be documented and signed off for governance and control purposes and preferably saved in a central repository (i.e. a database of cases assessed whether or not proceeding (including all workings)).

8.3.8.2. The tax administration should design templates containing key information relevant to their domestic requirements. Ideally these should contain:

- Statutory filing requirements (e.g. tax number etc.);
- The nature of the transactions and risks identified;
- The quantum;
- The jurisdictions with which the transactions occurred;
- The information reviewed e.g. the financial statements, tax return etc.; and
- The outcome of the risk identification and assessment process i.e. what was recommended and why. This would be the most critical aspect.

8.4. Planning for transfer pricing examination

8.4.1. Formation of Examination Team

8.4.1.1. Where the transfer pricing unit (TPU) of the tax administration decides to examine transfer pricing, the examination team should ideally be formed as follows:

1. An overall manager who has overall responsibility for more than one audit;
2. A team leader who will manage the day-to-day examination of a taxpayer;
3. A domestic examiner who is responsible for audit activities primarily relating to domestic issues;
4. An international examiner who is responsible for audit activities primarily relating to international issues;
5. A transfer pricing economist who provides economic analysis and support for the audit;
6. A lawyer who is available for consultation on legal aspects and may be involved in audit planning and implementation; and
7. A computer audit specialist who assists in developing the software needed to analyze computer readable data received from the taxpayer, and to organize data to assist the domestic and international examiners and economists in analyzing transfer pricing issues.

8.4.1.2. The above persons may not always be in one examination team and may be provided as necessary. One or more of them may not be present in an examination team. One person may perform the functions of two or more of the above persons. It is noted that the above seven different kinds of people illustrate the knowledge and expertise needed for a transfer pricing audit team. The international examiner, the transfer pricing economist and the lawyer are likely to be present in most cases.

8.4.1.3. The international examiners are indispensable in the light of the international nature of transfer pricing. The international examiners receive special training in international issues and, in many cases, are more senior and experienced than domestic examiners. The team leader often consults the international examiner.

8.4.1.4. Transfer pricing economists should be involved from the inception of the audit. An economist is almost always involved in (i) the functional analysis of the taxpayer's business, (ii) assisting in the selection of comparables, (iii) assisting in the selection of the methodology to be applied, (iv) providing an analysis of whether the prices for the transactions in question meet the arm's length standard, (v) assisting the audit team with respect to the economic arguments with the taxpayer, and (vi) preparing or assisting the preparation of a report which may represent the position of the team.

8.4.1.5. The lawyer may be involved at an early stage. Important substantive or procedural decisions will often be reviewed by the lawyer. The lawyer will be consulted concerning the procedures to be used for information gathering and may be involved in drafting questions posed in information requests and may also participate in interviews of company personnel. The lawyer is expected to contribute to more carefully crafted inquiries for information and to resolve administrative and substantive issues. Also, the participation of the lawyer in the audit process may mean the preparation of the case for litigation.

8.4.2. Supervision of Examination

8.4.2.1. A key issue for a tax administration is how to keep the execution of transfer pricing taxation uniform over the whole country. This is especially a pressing problem for a country which has a vast area to cover. An illustration of an effort to solve this problem can be seen from the case of Japan.

8.4.2.2. When Japan enacted its transfer pricing tax legislation in 1986, one of the issues was how to administer the transfer pricing taxation uniformly all over the country. There were twelve regional taxation bureaus, while a single unit had to supervise the transfer pricing assessments done by these bureaus. From the outset it was made the rule that prior approval from the Director (International Examination) in the Large Enterprise Examination Division of the central National Tax Agency had to be obtained before each transfer pricing division could issue a correction notice to adjust transfer pricing of a taxpayer. Such an approval request should be supported by an explanation of the facts of the case and the reasons for the adjustment; transfer pricing divisions were also encouraged to consult the Director (International Examination) during the course of the examination.

8.4.2.3. This was possible at the early stages of transfer pricing enforcement because the number of transfer pricing cases was small at that stage. As the frequency of transfer pricing taxation increased, however, it became impossible for the Director (International Examination) to control all transfer pricing cases. Therefore, gradually, the supervisory power has been delegated to the Senior Examiner (International Taxation) at each Regional Taxation Bureau. The Director (International Examination) now supervises only the larger transfer pricing audit cases. It is now possible to supervise the execution of transfer pricing taxation at the level of the Taxation Bureaus as the number of tax officials who share common knowledge and expertise in transfer pricing has increased considerably.

8.4.3. Issues for Examination/Examination Plan

It is necessary to decide what issues will be investigated for a transfer pricing examination. This involves the establishment of a transfer pricing examination plan; see 6.1 for further details on the examination plan.

8.4.4. Audit Timetable

A transfer pricing audit usually takes a longer time than an ordinary tax audit because the scope of the factual matters to be investigated is much broader and the amount of time and effort for transfer pricing analysis is much greater. The rule of thumb for the time needed would be an

average of one to two years. Experience has shown that examinations rarely proceed in accordance with the timetables set forth in the examination plan. The main reason is that the progress of an examination depends on whether the information requirements set forth in the examination plan are satisfied. Unfortunately, the required information is not always obtained on time. It may be necessary to check the progress of the audit periodically to reconsider the audit timetable and the extent of information needed by the audit team.

8.4.5. Information already in hand

Tax authorities are already in possession of certain information before starting a transfer pricing audit. These include (i) tax returns filed; (ii) financial statements attached to the tax returns; (iii) certain schedules relating to transfer pricing attached to tax returns; and (iv) statutorily required information returns. These form important basic data for a transfer pricing audit.

8.4.6. Information to be collected

8.4.6.1. The first major activity in a transfer pricing audit is the gathering of information that the tax authorities consider necessary to decide whether to accept tax returns as filed or to propose transfer pricing adjustments. The tax authorities rely primarily on the taxpayer to provide that information.

8.4.6.2. It should be noted that the taxpayer's cooperation in providing the required data is essential in a transfer pricing audit which is different from ordinary tax audits. In a transfer pricing audit the taxpayer is often asked to create data or to put data in order for the audit team. In the case of an ordinary tax audit the taxpayer has no obligation to create a document for tax examiners. Further, it is often necessary to create documents or to put necessary data in an orderly form to understand the business operations and to proceed to the analytical stage. Taxpayers are expected to cooperate with the audit team in providing the necessary data, and a cooperative atmosphere during transfer pricing audits is desirable and to be encouraged.

8.4.6.3. The principal means for the audit team to collect the necessary information is the written information request. The information request is usually backed up by criminal or other penalties to be imposed in the case of failure to comply with the request. Multiple information requests are likely to be issued by the audit team during a transfer pricing audit. The time given for responding is usually a few weeks unless the taxpayer is expected to take a longer time to obtain and/or prepare the required information. Tax authorities can also utilize the exchange of information provision in an applicable tax treaty.

8.4.6.4.. It should be noted that a problem often seen are the challenges in enforcing an information request which seeks a document or information not held by the taxpayer under investigation but held by a related party outside the country. In the case of Japan, the Japanese taxpayer is required to make efforts to obtain the documents and accounting books held by its related party outside Japan. While it may be desirable for the Japanese tax authorities to have stronger means to enforce the provision in Japan of such documents and books, they are provided with the statutory authority to impose presumptive taxation if the requested data is not submitted by the taxpayer.

8.4.6.5. As a more stringent example the United States has more forceful means of obtaining documents located outside the country. The Internal Revenue Service (“IRS”) may issue a Formal Document Request (“FDR”) to a taxpayer to request foreign-based documentation under Section 982 of the Internal Revenue Code (“IRC”) after normal request procedures have failed. If the taxpayer fails to substantially comply with the FDR within 90 days it may be precluded from introducing any foreign-based documentation covered by the FDR as evidence at a trial where the documentation is relevant. Secondly, the IRS can request a taxpayer to obtain authority from a foreign related entity to act as an agent of that entity for the purposes of a summons under Section 6038A(e) of the IRC. Where the taxpayer fails to obtain the authorization, the IRS may determine the amount at issue based solely on the information available to it. Thirdly, the Third-Party Summons procedure is available to the IRS under Section 7602 of the IRC. The IRS must provide “reasonable notice” to the taxpayer before contacting any other party regarding the taxpayer’s tax liability and must provide to the taxpayer a list of the persons contacted by the IRS periodically or upon the taxpayer’s request.

8.4.7. Statute of limitations as provided for in the domestic law

8.4.7.1. The statute of limitations for transfer pricing cases may be the same as or different from that for ordinary tax cases. The United States applies the same three year statute of limitations to both ordinary tax disputes and transfer pricing disputes. The United Kingdom (six years), Germany (four years) and France (four years) have the same statute of limitations for both.

On the other hand, Japan applies a statute of limitations of six years to transfer pricing cases while the statute of limitations on ordinary corporate income tax liabilities is five years. Canada’s statute of limitations is six years for transfer pricing cases and three years for ordinary tax cases.

8.4.7.2. Another aspect of the statute of limitations is the fact that in the United States a

taxpayer can waive the benefit of the statute of limitations but that in certain other countries including Japan the state of limitations is fixed and the benefit cannot be waived by a taxpayer.

8.4.8. Approvals and sign-off

A transfer pricing audit, once it has started, will take a considerable time and effort for the examiners. It is desirable to require the approval and sign-off by a superior officer or the committee of transfer pricing audits before the examination starts from the viewpoint of effective use of the tax administration's human and other resources.

8.5. Preliminary Examination

8.5.1. Desk Audit

As stated in subsection 4.5., the tax authorities have certain transfer pricing information in their possession before a transfer pricing audit starts. A desk audit of such information, especially financial statements, should be made to evaluate whether there are any transfer pricing issues. For instance, computing the following financial ratios based on tax and financial data will be useful.

- (1) Gross profit to net sales;
- (2) Operating profit to net sales;
- (3) Operating expenses to net sales;
- (4) Gross profit to operating expenses (Berry ratio); and
- (5) Operating profit to average total assets.

Comparing the taxpayer's financial ratios to applicable standard industry ratios is useful if standard industry ratios can be found. Substantial deviations from standard industry ratios may indicate a transfer pricing problem. The findings from the desk audit should be analyzed to determine what further action is needed.

8.5.2. Understanding the Taxpayers' Business

8.5.2.1. Understanding the taxpayer's business operations is an essential part of the transfer pricing examination. This study can be done before starting a transfer pricing audit and even after starting it, and can include an understanding of the following:

- (i) The taxpayer's operations;
- (ii) The operations of its affiliates (domestic and foreign);
- (iii) The relationship between the taxpayer and its affiliates (domestic and foreign);
- (iv) The role each entity plays in carrying out the activities of the controlled group; and
- (v) How much control and direction the taxpayer receives from the headquarters of the group

8.5.2.2. The following may be sources for gaining an understanding of the taxpayer's business operations:

- (i) Transfer pricing documentation;
- (ii) Annual reports;
- (iii) Securities reports;
- (iv) Books and other publications describing the taxpayer's operations;
- (v) Reports published by securities companies;
- (vi) Internal audit and management reports;
- (vii) Organization charts (the preparation of which may require the taxpayer's cooperation);
- (viii) Minutes of board meetings, committee meetings and shareholders' meetings;
- (ix) Policy and procedure manuals;
- (x) Internal approval documents;
- (xi) Written intercompany pricing policies;
- (xii) Customs declaration documents;
- (xiii) Sales catalogues, brochures, and pamphlets; and
- (xiv) E-mails, faxes and other written correspondence between the taxpayer and its affiliates.

8.5.2.3. The following questions may be asked in order to understand the taxpayer's operations:

A. If the taxpayer is engaged in the distribution of products:

- (i) Are affiliates manufacturing the same or similar products to those handled by the taxpayer?
- (ii) Is technology transferred between affiliates and the taxpayer?
- (iii) Are trademarks and other marketing intangibles being used to market the product?
- (iv) Which members of the controlled group developed the trademarks and other marketing intangibles?
- (v) Which members of the controlled group advertise?
- (vi) Which members of the controlled group created the sales tools?
- (vii) Which members of the controlled group created and maintained the list of customers?

B. If the taxpayer is engaged in the manufacturing of products:

- (i) Are affiliates distributing or selling the same or similar products to those the taxpayer manufactures;

- (ii) Is the taxpayer using the same or similar manufacturing intangibles to those its affiliates are using?
- (iii) What patents and/or know-how are involved in the relevant technology?
- (iv) Is there a cost sharing agreement?
- (v) Did affiliates or the taxpayer buy into a cost sharing agreement?
- (vi) What research and development is conducted?
- (vii) What members of the controlled group do research and development?
- (viii) How are the results of research and development disseminated among members of the controlled group?

8.5.2.4. As intangibles are an important aspect of the taxpayer's business, gaining an understanding of the following intangibles may be useful:

- (i) Manufacturing and marketing intangibles;
- (ii) Domestic and foreign patents and any prosecutions involving the taxpayer;
- (iii) Licenses and assignments;
- (iv) Patent litigation involving the taxpayer;
- (v) Domestic and foreign trademark registration and trademark litigation involving the taxpayer; and
- (vi) Copyright registrations at the patent or copyright office.

8.5.3. Understanding the industry in which the taxpayer operates

In order to understand the taxpayer's industry, the following procedures may be used:

- (i) Identifying the industry association;
- (ii) Reviewing the industry association's publications and website;
- (iii) Reviewing industry guidelines used by the taxpayer;
- (iv) Consulting with various industry experts;
- (v) Consulting various books and articles on the industry;
- (vi) Identifying competitors in the same industry;
- (vii) Comparing the competitors' activities with those of the taxpayer; and
- (viii) Comparing the competitors' financial data with those of the taxpayer.

8.5.4. Approval

The approval of a superior officer will usually be required before embarking on a full scale transfer pricing audit of the taxpayer when the preliminary examination is completed.

8.6. Audit procedure

8.6.1. Audit approach

The examiners need to establish the transfer pricing examination plan, which may be divided into two parts:

- Part one identifies the audit team, the information they expect to obtain and the timetable for the examination. This part can be disclosed to the taxpayer under investigation.
- Part two identifies the tax administration's resources to be devoted to the examination, the accounts and transfer pricing issues under examination, the anticipated procedures for the examination of each issue, the personnel responsible for the various steps and the management procedures to be followed by the audit team. The information in part two is not disclosed to the taxpayer.

8.6.2. Notification to taxpayer

8.6.2.1. A transfer pricing audit usually brings the examiners into contact with the taxpayer by phone for scheduling an initial appointment. If such contact cannot be made the examiners will send a letter notifying that they will audit the taxpayer. This is the time when the examiners send the initial information request to the taxpayer. If contemporaneous documentation is required this is also the time to trigger the period of submission of the contemporaneous documents.

8.6.2.2. The audit is usually concerned with transfer pricing aspects only. However, an ordinary corporate income tax audit may develop into a transfer pricing audit if the examiners find it necessary to probe into transfer pricing aspects. The number of taxable years to be covered by an audit depends on the statute of limitations. If the statute of limitations is six years the taxable years to be covered may be five or six years.

8.6.2.3. The examiners will usually suggest a conference with the taxpayer. At the conference the examiners may discuss the schedule of the transfer pricing audit and certain ground rules.

If the taxpayer has submitted certain requested documents by then the examiners may also discuss the contents of such documents.

8.6.3 Gathering of information

8.6.3.1. How to gather information. Certain information needed for the transfer pricing audit is already in the hand of the tax authorities:

- (i) Tax Returns -Tax returns of the taxpayer are the most basic information documents.
- (ii) Financial Statements - Financial statements of the taxpayer under generally accepted accounting practice (GAAP) are often required to be submitted to the tax authorities together with the tax returns and constitute important financial documents for the transfer pricing audit.
- (iii) Documents attached to the tax returns - Taxpayers are often required to attach to a tax return a document relating to transfer pricing. For instance, in Japan Schedule 17(4) to the final tax return is required to disclose certain information on the taxpayer's transactions with its foreign related persons and it is often a useful information source for a transfer pricing audit. An English translation of this Schedule 17(4) is produced below.
- (iv) Information returns -Information returns may be required for transfer pricing purposes.

Schedule 17(4) Particulars concerning Foreign Related Persons

		Business Year or Consolidated Year		Corporation's Name		
Name, etc. of Foreign Related Persons	Name					
	Head or Main Office					
	Principal Business					
	Capital or Equity Amount					
	Classification of Special Relationship		Item No. ___	Item No. ___	Item No. ___	
	Percentage of Share Holding		Hold	%	%	%
			Held	%	%	%
	Operating Revenues, etc. in Recent	Business Year				
		Operating Revenues or Sales				
		Operating	Cost of Goods Sold			

	Business Year	Expenses	Selling, General and Administrative Expenses			
		Operating Profit				
		Net Profit before Tax				
Status of Transactions with Foreign Related Persons, etc.	Price of Inventory Asset Sale or Purchase	Receipt		mil.yen	mil.yen	mil.yen
		Payment		mil.yen	mil.yen	mil.yen
		Calculation Method		mil.yen	mil.yen	mil.yen
	Price of Service Rendition	Receipt		mil.yen	mil.yen	mil.yen
		Payment		mil.yen	mil.yen	mil.yen
		Calculation Method		mil.yen	mil.yen	mil.yen
	Rental of Tangible Fixed Asset	Receipt		mil.yen	mil.yen	mil.yen
		Payment		mil.yen	mil.yen	mil.yen
		Calculation Method		mil.yen	mil.yen	mil.yen
	Royalty of Intangible Fixed Asset	Receipt		mil.yen	mil.yen	mil.yen
		Payment		mil.yen	mil.yen	mil.yen
		Calculation Method		mil.yen	mil.yen	mil.yen
	Interest of Loan or Borrowing	Receipt		mil.yen	mil.yen	mil.yen
		Payment		mil.yen	mil.yen	mil.yen
		Calculation Method		mil.yen	mil.yen	mil.yen

8.6.3.2. Information request: Other necessary information will be requested by the audit team. The audit team's authority for making the information request is based on the tax authorities' general investigation authority provided for in the tax law. Furthermore, certain countries have specific statutory provisions for requesting information regarding transfer pricing issues.

8.6.3.3. Interviewing personnel of the taxpayer: It is useful to interview the personnel of the taxpayer engaged in marketing and sales and those in the accounting and financial departments. See 6.11 for more details.

8.6.3.4. Visiting taxpayer's facilities: It is often useful to visit a sales shop and a factory of the taxpayer to understand the taxpayer's business. During the audit the audit team may want to arrange this visit with the taxpayer. See 6.12 for more details.

8.6.3.5. Other Sources: Necessary information can also be collected from other sources such as the taxpayer's website, the taxpayer's submission of periodic financial data to the securities

regulatory agency (if the taxpayer's shares are listed on a stock exchange), business journals, other tax filings (related and unrelated to the taxpayer), etc. If the information is publicly available the audit team can freely use the contents of such information but if it is confidential the audit team must exercise care in disclosing such information.

8.6.4 Sources of information

8.6.4.1. The principal information source is the taxpayer. The taxpayer's books, records and other written documents, and its directors and employees are the principal sources of information.

8.6.4.2. A former employee or director of the taxpayer may also be a source, if necessary. In this event the former employee or director may be bound by a contract with the taxpayer not to disclose any secret information. This often causes a difficult legal question as to whether the former employee is obliged to disclose the requested information to the tax authorities. This question must be resolved in the light of the domestic law of the country concerned.

8.6.4.3. A third party is also a possible source of information. For example, Japanese tax law authorizes the Japanese tax authorities to request information from a corporation engaging in a business activity which is of the same type or examine the accounting books and documents of that person or corporation (Japanese Special Taxation Measures Law art. 66-4, paragraph 8). Tax returns of a third party in the same business will also be useful sources of information. When a third party's information is used the tax authorities are confronted with a statutory obligation of confidentiality when dealing with the taxpayer. This is often discussed in the context of secret comparables.

8.6.5. Language

8.6.5.1. The documents a taxpayer possesses with respect to its transactions with a foreign related party are often written in a foreign language that tax auditors may not understand. Tax law in most countries is generally silent as to which side should translate a foreign language in the documents necessary for transfer pricing audit. If the documents are voluminous the cost of translation is substantial.

8.6.5.2. When the relevant documents are written in a foreign language the examiners ask the taxpayer to translate the foreign language into the domestic language at its own cost, and the

taxpayer is often cooperative as a matter of practice. However the legal basis for the practice is not always clear.

8.6.5.3. If a document necessary for a transfer pricing audit is written in a foreign language and cannot be understood by the examiners, it will be the party with the burden of proof that will suffer a disadvantage.

8.6.5.4. The English language may have a unique position as a foreign language. In most non-English speaking countries tax examiners in charge of transfer pricing taxation are trained to understand English and may be able to read documents in English.

8.6.6. Types of information to be gathered

8.6.6.1. General Information: General information required for a transfer pricing audit includes (i) a corporate profile; (ii) the organization of the taxpayer and the related parties; (iii) the transactions or business flows; (iv) a list of manufacturing and/or sales facilities; (v) a list of directors and employees; and (vi) a diagram of group affiliates with capital relationships.

8.6.6.2. Financial information: The taxpayer's financial statements provide the basic financial information. However the transfer pricing audit is often focused on the sales or purchases of particular products, the provision of particular services or the licensing of particular technology. It then becomes necessary to segment revenues, expenses, gross profit and/or operating profit. A segmentation of the profit and loss statement is thus often conducted, focusing on transactions under review by the tax auditors. The preparation of segmented profit and loss statements will require additional work by the taxpayer, who knows the details of the profit and loss statements. The accurate review and assessment of the financial results would be impossible without segmented profit and loss statements.

8.6.6.3. Third party information: Third party information required is basically comparable data. The sources of the third party information may vary depending on the possibility of finding appropriate comparables.

8.6.7. Points for examination at the initial stage

8.6.7.1. In order to correctly ascertain whether any problem exists in relation to the transactions in the examination process, each case should be examined carefully, bearing in

mind the circumstances of each transaction. In conducting a transfer pricing audit the following points should be taken into consideration along with the functions performed, risks assumed and assets used by the taxpayer and the persons compared:

- 1) Whether the gross and operating profit margins arising from related transactions of the taxpayer are excessively low compared with those of other transactions conducted by the taxpayer with unrelated persons in a similar market and which are similar in quantity, market level, and other respects.
- 2) Whether the gross and operating profit margins arising from related transactions of the taxpayer are excessively low compared with those of other unrelated persons engaged in the same category of business that are similar in quantity, market level, and other respects.
- 3) Whether the taxpayer's gross and operating profit margins arising from related transactions are relatively low compared with those of the related persons arising from the same transactions.

8.6.7.2. Prior to the calculation of arm's length prices, examinations should be conducted from different viewpoints in order to determine whether there exist any problems regarding transfer pricing and to ensure that the examinations are conducted effectively. The following methods could be used:

- 1) Verification of whether or not the gross and operating profit margins of related transactions under the examination are within the range of the profit margins of uncontrolled transactions in the same business category and substantially similar to the related transactions in terms of quantity, market level and other respects.
- 2) Use of the average value of the consideration or profit margins for related transactions or transactions deemed comparable with the related transactions during a reasonable length of time before and after a taxable year under examination. This may be done if it is considered inappropriate to examine the price of inventory products and other aspects of the related transactions based only on the information for each relevant taxable year, due to considerable fluctuations in prices reflecting changes in public demand, product lifecycle, or other such factors.

8.6.7.3. Once the transfer pricing audit starts, various aspects of arm's length pricing will be involved and will consume a large quantity of time. After the above examinations, it may be useful to pause before starting the calculation of an arm's length value, which will take up the

best part of the transfer pricing audit. The auditor should review whether continuing the transfer pricing audit would likely produce a fruitful result from the viewpoint of efficiency.

8.6.8. Contemporaneous documentation

Contemporaneous documentation is explained in detail in Chapter 7. The contemporaneous documentation the taxpayer has prepared will be an important document for the examiners, and will be one of the first documents they request. The taxpayer is usually required to provide the examiners with the contemporaneous documentation within a specified number of days after a request from the tax authorities. Such documentation should demonstrate that the transfer pricing method and its application provide the most reliable measure of an arm's length price. This represents the first opportunity for the taxpayer to persuade the examiners that the transfer pricing is appropriate. If incomplete or inaccurate the contemporaneous documentation may provide the examiners with a road map for their transfer pricing audit.

8.6.9. Information request list

The following is a sample list of information documents required from a corporation engaged in the distribution of products on the assumption that the taxable years under audit are five years. The requested information should be the most up to date unless otherwise required.

1. Corporate profile brochure (including the corporate group's history);
2. Organizational chart (setting out the number or names of employees);
3. Transactional structure – a business flow chart (invoicing and settlement, and actual delivery flow);
4. List of Shops: location, size, opening times, sales revenue, staffing, prices, contractual terms with customers (consignment / cash Sales etc.) including data on the latest three years for sales, revenue and staffing);
5. List of directors;
6. Equity relationship structure of group companies;
7. Basic business agreements, distribution agreements and other agreements with the related party;
8. Corporate profile of the related party;
9. Documents related to determination of arm's length price;
10. Transfer pricing determination method and list of margins by categories of product for five years;

11. Latest financial data regarding the sales, cost of goods sold, operating expenses, operating profits and profit before tax for five years;
12. Group global consolidated basis profit and loss statement and ratio of taxpayer's sales towards group global sales for five years;
13. Segmented profit and loss statements from the related transactions of the related party (if the taxpayer is the purchaser) or the taxpayer (if the taxpayer is the seller) for five years;
14. List of gross and operating profits by category, by product and by distribution channel with detail of losses on disposal of assets and losses from obsolescence for a period of five years; and
15. Top ten products in sales by category (name of product, purchase price and retail prices, personnel expenses, advertising expenses and sales promotion expenses) for five years.

8.6.10. Supplemental information reports

As the transfer pricing examination progresses many more questions will arise in the minds of the examiners, and accordingly many supplemental information requests will be issued by the examination team. This part of the examination process tends to be prolonged.

8.6.11. Request for interviews

8.6.11.1. It is common in a transfer pricing audit for the examination team to request interviews with key company personnel involved in transactions with related parties. The interviews assist the examination team's functional analysis for purposes of determining the functions performed by the taxpayer and related parties and determining comparability. Transfer pricing economists and the international examiners on the examination team will almost always participate in the interviews, and a lawyer will also be involved. The following aspects are pertinent to the taxpayer's responses to the requests for interviews:

8.6.11.2. Personnel to be interviewed: The examination team will choose the personnel to interview by requesting organization charts. The personnel to be interviewed are decided by the examination team based on mutual discussion of the functions of the personnel in the organization charts.

8.6.11.3. Conduct of interview: Interviews are usually conducted in a cooperative manner. The taxpayer may work with the examination team to set the rules of the interview by an advance agreement, to avoid confusion. The advance agreement will make it less likely that the taxpayer's efforts will be interpreted as attempts to manipulate the information obtained at the

interview. For example, the taxpayer may wish to arrange for the examination team to meet with a group of employees, rather than meet each person separately. In this way the employees have an opportunity to consider the responses of other individuals. On the other hand, the examination team may want to interview each person separately.

8.6.11.4. Use of interpreters: If the person to be interviewed is a foreigner it is advisable to use an interpreter even if he can speak the language fairly well. The use of an interpreter will avoid the possibility of misunderstanding questions and allow the interviewee time to formulate responses.

8.6.11.5. Recording of interviews: If an interview is recorded both parties should keep a copy of the record. It may be more useful to have a stenographic record than an audio recording, considering the possibility of future use. If no record of an interview is taken the examination team may produce a summary of the interview for the signature of the interviewee. A careful review of the written summary is needed in such event.

8.6.11.6. Preparation of interviewees: The interviewees should be made familiar with the process and should understand the procedures, purpose and importance of the interview.

8.6.12. Request to visit facilities

The extent of cooperation for the tax examiners' visit to taxpayer's facilities will vary from case to case. Representatives of the examination team could be accompanied on the visit by an employee of the taxpayer who can describe the activities at particular locations and respond to questions. The tour guide should consider the tour as being similar to an interview or an opportunity to present factual portions of the taxpayer's case as his explanation may affect the taxpayer's position in describing objects or operations on the tour.

8.6.13. Secret Comparables

There is a question concerning secret comparables which often surfaces in connection with transfer pricing audits. Confidential information from other taxpayers may be reviewed for general information or hints for a further investigation. However, using such information to establish comparables will be a problem. The OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administration (2010) states at para. 3.36 as follows:

“Tax administrators may have information available to them from examinations of other taxpayers or from other sources of information that may not be disclosed to the taxpayer. However, it would be unfair to apply a transfer pricing method on the basis of such data unless the tax administration was able, within the limits of its domestic confidentiality requirements, to disclose such data to the taxpayer so that there would be an adequate opportunity for the taxpayer to defend its own position and to safeguard effective judicial control by the courts.” The position expressed above should be taken seriously.

8.6.14. Attorney-client privilege and work product doctrine

The attorney-client privilege and work product doctrines are well developed in the United States, although such privilege and doctrine may not be developed in other countries. The attorney-client privilege protects communications between the client and the attorney or the attorney’s agents. Where legal advice is sought from a lawyer in his capacity as such, the communications relating to that purpose made in confidence by the client are protected from disclosure by the client or by the lawyer unless the protection is waived by the client. The attorney work product doctrine protects materials prepared for trial or in anticipation of litigation by an attorney or his agent. When litigation is reasonably anticipated in relation to the transfer pricing examination, the due consideration of the attorney-client privilege and the work product doctrine would be important, where they are applicable.

8.6.15. Comparison Chart

In the process of examination, it may be useful to prepare a comparison table of the tested party and the comparable. A simple example (which can be more detailed) of a comparison table is shown below.

Corporate Names Items	Tested Corporation	Comparable Corporation
Industry code		
The last day of accounting period		
Contents of business		
Principal products handled		
1. _____ (__%)		
2. _____ (__%)		

3. _____ (%)		
Principal vendors		
Principal purchasers		
Indigenous R&D		
No. of employees		
Territory		
Paid-in capital		
Amount of borrowing		
Sales (five years)		
Gross profits and margins (five years)		
Operating profits and margins (five years)		
Gross profit margins after adjustments		

8.7. Narrowing of issues – development of tax authorities’ position

8.7.1. Refining understanding of the taxpayer’s business

During the examination process the examination team needs to review information it has obtained earlier concerning the taxpayer’s business in the light of the taxpayer’s responses to

the information requests and other information gathering activities. This will lead to a refined understanding of the taxpayer's business as such information will affect the choice of comparable transactions or companies.

8.7.2. Refining understanding of the taxpayer's industry

Similar efforts will be needed in refining the understanding of the taxpayer's industry. The examination team will review product line financial statements for multiple years to detect unusual fluctuations or deviations from industry norms that may not result from business cycles or product life cycles.

8.7.3 Refining functions and risk analysis

8.7.3.1. The examination team will need to understand the functions and risks of the taxpayer and its affiliates before attempting to determine whether particular transactions or companies are comparable to the taxpayer. The examiner will need to identify the functions that are most important in creating value in the taxpayer's related party transactions. The examiners use information obtained in information requests and interviews to trace the flow of transactions through the taxpayer. They determine who performed significant functions, whether any valuable intangibles were involved and reasons for the transactional structure. .

8.7.3.2. The examiners will need to determine the effect of intangible property on the transactions. As higher risk justifies a higher return, the examination team will determine which companies within the group bear market risks (such as fluctuations in cost, demand, pricing, and inventory activities), foreign exchange risks (such as fluctuations in foreign currency exchange rates and interest rates), credit and collection risks, product liability risks and general business risks and whether they receive an appropriate benefit.

8.7.3.3. The examiners analyze the economic conditions of the taxpayer's transactions to later identify comparable transactions and companies. The taxpayer will need to participate in this area of the examination to ensure that inappropriate comparables are not used. In summary, refining functional and risk analysis is important in reaching the correct results of arm's length transactions. See further Chapter 5, and Chapter 6, Para 6.1.2.

8.7.4. Choice of transfer pricing method

After refining the functional and risk analysis, the examination team will choose the transfer pricing method in the light of that analysis. See Chapter 6 on selection of appropriate methods.

8.7.5. Examiners' interim opinion or economist's report

Toward the end of the examination procedure, the examination team produces an economist's report or examiners' interim opinion, unless the examiners judge that no adjustment should be made. It is often helpful to resolve issues or agree to disagree on certain issues while the information is fresh rather than delaying the resolution until the end of the examination process. The taxpayer has significant flexibility at this stage. He may refuse and argue, accept or suggest modifications of the report or opinion.

8.7.6. Draft proposed adjustments

When the examination team thinks it has developed transfer pricing issues and exhausted arguments with the taxpayer, it will produce the draft proposed adjustments. In certain countries, the proposed adjustments may be combined with the examiners' interim report described above depending on the circumstances. This will be the last chance for the taxpayer to determine whether to keep fighting or to make a settlement with the examination team.

8.7.7. Formal notification to taxpayer of proposed adjustment

Unless the taxpayer and the examination team can reach agreement, the formal notification of proposed adjustment will be issued. In certain countries, the issuance of a formal notification of proposed adjustment is statutorily required for the issuance of the adjustment order in which event the taxpayer is given the opportunity to accept the notification within a stipulated time (for instance, 30 days) and/or notify any set-offs. In certain other countries this formal notification procedure does not exist.

8.7.8. Issuance of Adjustment/Correction

If the taxpayer does not accept the above formal notification of proposed adjustment, a final adjustment (i.e. a notice of deficiency) will be issued. In certain countries this final notice of correction will be issued without going through the formal notice of proposed adjustment.

8.7.9. Settlement opportunities

Throughout the process of the transfer pricing examination, the opportunity for settlement with the examination team may arise. Proper transfer pricing planning and documentation and active involvement in the examination process may facilitate a settlement with the examination team. If a settlement cannot be achieved with the examination team, it may be achieved with the administrative appeals officer. Depending on the circumstances a settlement, the terms of which may vary, may be an effective resolution by saving the time and the costs of disputes.

8.8. Case closure

The case closure needs to be properly documented, as every decision taken can potentially be subject to litigation. The table below provides a clear documentation process to ensure the information needed is recorded and to guarantee that the required process has been followed. The Audit Report is also captured in the table with all the required details.

AUDIT CLOSURE TEMPLATE

AUDIT TEAM:		DATE:	
TAXPAYER NAME:		TIN:	
		TAX PERIOD:	
PHYSICAL ADDRESS:		AUDIT TYPE:	
DATE OF COMMENCEMENT:		DATE OF COMPLETION:	

TAXPAYER’S NATURE OF BUSINESS & MAIN ACTIVITIES:

MEMBERS OF AUDIT TEAM			
	NAME	DESIGNATION	EMPLOYEE ID.NO.
1			
2			
3			
4			
5			

TAX TYPES COVERED	TAX PERIODS AUDITED

1. AUDIT OBJECTIVE

2. AUDIT SCOPE

3. RISKS IDENTIFIED AT PROFILING AND PLANNING STAGE

4. RISKS IDENTIFIED DURING AUDIT EXECUTION

5. RECORDS REVIEWED & AUDIT METHODOLOGY USED (Work done)	Cross reference to working papers
•	
6. AUDIT FINDINGS i.e. observations on compliance (accuracy, completeness and validity)	Cross reference to working papers
•	
•	

7. SUMMARY OF REVISED ADJUSTMENTS/ASSESSMENTS AND TAX PAYABLE

TAX TYPE	PERIOD AUDITED	REVISED TAX	PENALTY	INTEREST	TAX PAID	TAX DUE

7A. SUMMARY OF LOSSES CARRIED FORWARD /UNABSORBED CAPITAL ALLOWANCES RELIEVED

YEAR	LOSS C/F RELIEVED	UNABSORBED C/A RELIEVED
2006		
2007		
2008		
2009		
2010		
2011		

8. TAXPAYER'S BANK ACCOUNT(S) DETAILS	
BANK NAME	ACCOUNT NUMBER

9. TAXPAYER CONCURRENCE, RECOMMENDATIONS, OR COMMENDATIONS

10. INTERNAL RECOMMENDATIONS (exclude from the taxpayers copy of audit report)

11. CHALLENGES ENCOUNTERED & LIMITATIONS TO THE AUDIT

12. OBSERVATIONS BY LEVEL SUPERVISOR
Name, Signature and date

13. OBSERVATIONS BY TEAM LEADER

14. ENDORSEMENT BY MEMBERS OF THE TEAM			
NAME	DESIGNATION	SIGNATURE	DATE

8.9. Relationship between transfer pricing audits and APAs

8.9.1. The merit of the advance pricing agreement (“APA”) is that once an APA is agreed on the pricing in accordance with the terms of the APA will not be disturbed by a transfer pricing examination. However there is a subtle relationship between an APA and a transfer pricing audit. There is a risk that information submitted to the tax authorities for the purposes of the APA may be used for the purposes of the transfer pricing audit. Also, while an APA application is being pursued a transfer pricing audit may be conducted before the APA is finalized.

8.9.2. As an example, the following measures are taken, in Japan:

- (1) In order to ensure confidence in the APA system, documents (other than factual documents such as financial statements, capital relationship diagrams and summary statements of business) received from a taxpayer for an APA review may not be used for a tax examination.
- (2) While an APA is in progress a tax examination on transfer pricing aspects will not be conducted for the years to be covered by the APA application (including the roll-back years).

The above measures give the assurance that a taxpayer’s pursuit of an APA will be protected.