

A series of articles based on our Global Transfer Pricing Conference in Shanghai, China – October 2015

Transfer Pricing Perspectives: Beyond boundaries





***Beginning with
the end in mind:
Audit ready preparedness
in an evolving compliance
environment***

Beginning with the end in mind: Audit ready preparedness in an evolving compliance environment



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Introduction

The intensity of transfer pricing disputes continues to escalate on the back of rapidly evolving transfer pricing reform, public scrutiny of multinational enterprises (MNEs), and access to greater resources by revenue authorities globally to enforce what has become an increasingly political issue.

This article discusses recommended best practice for the early prevention of disputes, together with perspectives on effective audit management in selected countries in Asia.

The transfer pricing audit landscape globally

Effective transfer pricing audit management is now more relevant than ever in view of increasingly co-ordinated multilateral approaches to transfer pricing compliance and audit management globally. This is demonstrated through the G20 and Organisation for Economic Co-operation and Development's (OECD) Base Erosion and Profit Shifting (BEPS) projects. This includes greater collaboration and transparency initiatives (i.e. country by country reporting) for information sharing amongst revenue authorities, which is likely to prompt further increases in audit activity as revenue authorities continue to target their fair share of MNE profits.

In the Asian region in particular, the growing scrutiny and increasing sophistication of revenue authorities has seen unparalleled growth in audit activity. For example, revenue authority collections have grown five-fold in China in the last five years.

Key audit risk areas

Arrangements that are likely to attract greater revenue authority scrutiny in the current environment include:

- Business restructures (particularly where valuable intangibles have been migrated),
- Intra-group financing arrangements,
- Loss making entities,
- Companies with significant related party dealings,
- Companies with a low effective global tax rate,
- Dealings with tax haven jurisdictions,
- Complex tax structures, and
- Services in low cost jurisdictions i.e., where location savings are arguably derived.

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Best practices for prevention of disputes up-front

The starting point for a robust transfer pricing defence position commences with sound analyses, policies and procedures.

However, preparation of transfer pricing analysis, documentation and policies for higher risk transactions should be inherently different from an analysis of a transaction that is likely to carry a lower risk profile in the eyes of a revenue authority.

In a rapidly changing world, with mobile workforces and fast changing technology, retracing steps years after a transaction occurs to identify relevant information can prove very difficult, and sometimes even impossible. Hindsight has shown that while the contemporaneous preparation of a robust 'audit ready' analysis may require more focussed effort up front, it results in substantial time and cost savings in the long run.



Practically, if one thinks about a robust transfer pricing analysis as consisting of a functional/ factual analysis, selection of the most appropriate transfer pricing method, application of that transfer pricing method (i.e. economic analysis), and ongoing implementation and monitoring of the arrangement, the following best practice tips and tricks can operate to reduce the likelihood of a revenue authority adjustment.

1. Functional/factual analysis

Almost all transfer pricing disputes hinge on a misunderstanding or disagreement between the parties around the facts relevant to establishing the arm's length price. That is, the facts that are critical to determining the key functions performed, assets utilised, and risks borne by the MNE, and in turn the key value drivers of the business.

With higher risk transactions, to establish a robust audit ready defence file a taxpayer needs to do more than simply "tell a story". Whilst the story may be factually accurate, proving the story in the event of a dispute requires a more extensive exercise focussed on establishing the appropriate granularity of facts through the contemporaneous preparation of documentary evidence, including:

i. Written statements

Where possible, written statements should be obtained from influential senior executives (e.g. heads of department, CFO and CEO) documenting the MNE's business strategy and value drivers.

Involving senior business officials contemporaneously and at the time of a revenue authority dispute can lend additional weight, particularly where it can be shown that the intercompany arrangement is driven by commercial rather than tax objectives.

Board documents and approvals together with public company statements can be an excellent source of contemporaneous documentary evidence in this regard.

ii. Legal agreements

Both related and unrelated third party agreements relevant to an intercompany arrangement should be prepared and maintained on file.

It is also important to evidence that the transaction has been implemented in accordance with the legal agreement (e.g. through

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invoices, written correspondence between the parties, and accounting entries).

Establishing the key terms of a transaction and intent of the related parties becomes increasingly difficult in the absence of a written agreement and leaves a taxpayer exposed to a greater risk of revenue authority disagreement as to the legal and economic effect of a transaction.

iii. Financial analysis

Financial analysis should be considered to quantitatively support claims made by business representatives where possible e.g. quantifying business improvements of a transformation initiative, or evidence relevant to the quantitative significance of a risk borne by a party such as insurance, warranty and credit claims etc.

iv. Third party analyst reports

Third party analyst reports of a company or industry can provide an independent and objective perspective.

v. Decision making processes

Given an increasing focus on people functions, particularly in the context of managing risk, contemporaneously preparing documentation evidencing the decision making process for key functions and risk processes can be particularly helpful. This might include process maps, curriculum vitae's, parameters of authority, and email correspondence. As a general comment, it is often valuable to play 'devil's advocate' throughout the functional analysis and fact finding stage from the perspective of a revenue authority. In this regard, it is helpful to cross-check statements made by personnel with evidence gathered from varying sources.

2. Selection of the appropriate transfer pricing method

There is often potential for revenue authority disagreement regarding the selection of the most appropriate transfer pricing methodology where the method is not codified or prescribed.

It may be useful to consider:

- The use of more than one method as a cross-check;

- Potential internal comparables. These should not be disregarded too quickly, and examined closely and adjusted for comparability where possible.
- Although a transaction might not be sufficiently comparable, it may provide a 'line in the sand' for the arm's length transfer price e.g. a cap or floor;
- Again, playing devil's advocate can be helpful. Consider mounting an argument for the use of a different methodology to identify flaws in your methodology.

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3. Application of the transfer pricing method

When applying the selected transfer pricing method, it can be helpful to take into account the following:

- Contemplate the validity of all publicly available sources for comparable information (e.g. annual reports),
- Evaluate and document the comparability factors in detail,
- Perform sensitivity and scenario analysis to sense check the risk of a revenue authority disagreeing with a particular economic variable.

4. Implementation and review

The above described analysis should be performed periodically to account for any changes in the business and economic environment.

It is particularly important to ensure as part of the implementation and review process that the MNE adopts the transaction as originally intended and contractually agreed.

Any variations or amendments to the arrangement should be documented contemporaneously.

Any changes should be communicated to the transfer pricing function as soon as possible.

Best practices during reviews and audits

It is important to develop and decide on a strategy for communicating and dealing with the revenue authority(ies) and internal business stakeholders early on in the process.

Some useful considerations to managing a revenue authority enquiry, which will be highly dependent on the nature of the dispute and operating jurisdiction, include:

Engage in dialogue with the revenue authority early to:

- understand the basis for their position/their key concerns,
- identify key areas of disagreement,
- resolve any misunderstanding of the facts;

Understand the relevance of the line of questioning and keep the enquiry on track;

- Understand your rights and responsibilities e.g. when responding to information requests;

- Ensure responses are robust and technically and factually correct and, where possible, supported with evidence;
- Consider the use of an internal steering committee and establishing governance around communicating audit developments internally.

Resolving transfer pricing controversies

A majority of transfer pricing disputes are ultimately settled as part of commercial negotiations on a principled basis.

Where settlement discussions are not fruitful, alternative dispute resolution approaches can be helpful in achieving an outcome satisfactory to both parties, including mediation or arbitration.

The use of independent experts or arbitrators can be helpful in this regard e.g. industry or economic experts.

In some jurisdictions advance pricing arrangements (APAs) and mutual agreement procedures (MAP) can provide an alternative means of pre-emptively preventing or resolving a dispute. MAP can provide a balanced perspective with input from a counterparty jurisdiction that can give rise to satisfactory outcomes on a multilateral basis.

Perspectives on audit environment and effective audit management in selected countries in Asia

China

The China State Administration of Taxation (SAT) has significantly increased its focus on transfer pricing in recent years. Key areas of focus for the SAT include:

- intra-group services and intangibles transactions,
- emphasising the importance of location specific advantages,
- requiring more extensive information to provide a holistic view of the group value chain and contribution of value chain participants, and
- enhancing the verification of the authenticity and accuracy of a taxpayers' related party disclosures with its financial accounts.

The SAT has strengthened its anti-tax avoidance monitoring system with emphasis on reviews of transfer pricing documentation and related-party transaction disclosures, single entity or group-wide multi-entity joint audits, follow-up administration after transfer pricing investigations, and management of self-adjustment by taxpayers.

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Transfer pricing audits in China almost always end with a negotiated settlement, as administrative appeals are not effective and litigations are rare. Robust analysis and effective communication are keys to successful audit management. MAP is frequently initiated as a remedy to avoid double taxation and APAs are commonly used to prevent disputes.

Recent trends indicate that taxpayers small and large are increasingly facing pressures to perform self-adjustments as an alternative to be under a formal investigation. However, resolving the dispute via a self-adjustment vis-à-vis a formal investigation should be considered having regards to the relative merits of either approach based on the particular case.

Japan

Transfer pricing audits can be conducted either as a part of a corporate tax audit or as a separate transfer pricing examination by the National Tax Agency (NTA).

During the audit, the tax authorities will conduct various interviews, look into detailed financial data, and request overseas information including segmented profit & loss data for cross-border transactions.

Presenting thorough transfer pricing documentation at the beginning of the audit is the key to preventing the tax authorities from conducting a prolonged transfer pricing audit.

APAs are very common in Japan and an effective means of cooperative compliance and dispute prevention. Over one hundred APA applications (a majority of them bilateral) are filed every year.

India

The Indian Revenue Service (IRS) is yet to establish risk based compliance processes and as a result audits all cross-border dealings in excess of INR 150 million (US\$ 2.5 million).

The following IRS trends and practices have been observed:

- Exchange of information between Income Tax and Customs Department;
- Use of social networking information (e.g. LinkedIn profiles) to audit functional characterisation;
- Exercise of power to record statements on oath, inspect office premises, obtain information from third parties, etc.;
- Exercise of power to apply the transfer pricing provisions in respect of transactions with non associated

enterprises in certain notified non-cooperative jurisdictions which lack effective exchange of information.

Disputes can be resolved via a Dispute Resolution Panel (DRP), which is a unique mechanism to pre-empt disputes. Further, APAs are commonly used by taxpayers to prevent disputes.

Key takeaways

MNEs should be aware of key audit areas across their operating jurisdictions and pre-emptively develop robust transfer pricing policies and procedures.

Specifically, taxpayer's should begin with the end in mind by anticipating revenue authority challenges, and developing robust documentary evidence to establish the fact profile and economics required to robustly defend its cross-border dealings.

Such analysis may prove more onerous initially, but will save significant time and resources in the long run.

Taxpayer's should begin with the end in mind by anticipating revenue authority challenges.

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