

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 tax revenue development for the country, but 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” high 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

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

8.2.1.2. Generally, two

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

utilized to train and develop

Filing information typically relates to questions on a tax return. This may

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 be the MNE's jurisdiction.

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

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 sc e r t 5 4 . 8 r 7 1

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

8.3.3.3. Jurisdiction 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

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 crossborder related party:

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

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

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 administrations 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 the identified; t 3 e ndr0 099g Ris1J /TT1 1 Tf 1.5275 0 TD 01 Tf ac (proc4 sho9Tf .8364 0 TD 0 Tc <0003>Tj /TT2 1 Tf .2207 0 TD .0077 Tc [(th)10.4(e)]0 outcomes

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

8.4.2. Supervision of Examination

8.4.2.1. A key issue for a tax

average of one to two years. Experience has shown that examinations rarely proceed in accordance with the timetable set forth in the examination plan. The main reason is that the progress of an examination depends on whether the

8.4.6.4. It should be noted that a problem often seen are the challenges in enforcing an information request which seeks a

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:

- (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)

8.5.4. Approval

The approval of a

If the taxpayer has submitted certain requested documents by then the

	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

taxpayeris often

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 appropriate 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

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

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 disposals 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

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 an event.

8.6.11.6. Preparation of interviewees: The interviewees should be made familiar with the process and should understand the procedure, 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. Represent case. <&J Y ĐÀ 0

“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

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 high 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

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 adjustments 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

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^{23Y}

TAX TYPE 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 AND AUDIT METHODOLOGIES USED (Work done)	Cross reference to working papers
6. AUDIT FINDINGS (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/F RELIEVED	UNABSORBED/A RELIEVED
2006		
2007		
2008		
2009		
2010		
2011		

8. TAXPAYER BANK ACCOUNT DETAILS	
BANK NAME	ACCOUNT NUMBER

9. TAXPAYER CONCURRENCE, COMMENDATIONS, COMMENDATIONS

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

11. CHALLENGES ENCOUNTERED & LIMITATIONS OF 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

ampô(â)ç5.9(â)Tc.(â)73.8Tf.â.43.26.57.26.69.20.0.0.00.06.09.21.5Ttâ.0.70.24.0.0.0.0.13.50.28.5.0

8.9. Relationshipbetween transfer pricing audits and APAs

8.9.1. Themerit 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 reviewed