

C.3. Audits and risk assessment

C.3.1. Introduction to Audits and Risk Assessment

C.3.1.1. As discussed in Chapter B.1, the 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 national tax 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.

C.3.1.2. The outcome of an effective audit process has two aspects:

1. Increased future compliance (which indirectly contributes to future tax revenue and protection of the tax base); and
- 2.

advantages and disadvantages. There is no established best practice and tax administrations should decide which option suits their needs. 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 C.5. and following for further analysis of the centralized and decentralized models.

C.3.2.2. Staffing and Resourcing

C.3.2.2.1. Transfer pricing is not an exact science and requires judgement and discretion; audits are often complex and time intensive. Owing to this, it is critical that adequate resourcing is available for such 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 nevertheless critical to the efficient, timely and successful conclusion and even resolution of an audit.

C.3.2.2.2. 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 an attractive aspect of government work and tax administrations in developing countries need to leverage off this to attract and retain transfer pricing resources. See further Chapter 4, Paragraph 4.6.1. and following paragraphs.

C.3.2.2.3. Most tax administrations employ a variety of skills within transfer pricing units. These include economists, lawyers, accountants, industry experts and generalists. Over time those become 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.

C.3.2.2.4. 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 otherwise). 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

C.3.3.1.4.

C.3.3.2.6. 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 r

C.3.3.2.12. 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.

Category 4: Thin capitalization

C.3.3.2.13. This category 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

C.3.3.2.19. 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 summarized in the table below:

Table C.3. 1: Possible “Flags” Suggesting Further Investigation		
TYPE	INBOUND TRANSACTIONS/MNEs	OUTBOUND TRANSACTIONS/MNEs
Funding	Thin capitalization	Interest free loans
Interest rates	Excessive interest rates	Too low interest rates
Goods	Offshore procurement/sourcing companies to keep profits offshore General mis-pricing (intentional or unintentional)	Offshore marketing companies to keep profits offshore General mis-pricing (intentional or unintentional)

Services	Excessive fees relative to benefit provided Charging when no service received Duplication/shareholder services	No charge at all Excessively low fees relative to benefit provided
----------	--	---

Intangibles/Intellectual

C.3.3.3.3. Alternatively, the focus could be on higher risk transactions with a higher possible

- Purchases;
- Loans, including interest received and/or accrued;
- Royalty payments;
- Service fees;
- Derivatives transactions;
- Debt factoring or securitization transactions; and
- Share remuneration transactions.

C.3.3.4.2. Publicly available data is a useful source. This includes 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.

C.3.3.4.3. 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, are often freely available, and can also be helpful in identifying similar issues in another jurisdiction.

Access to transfer pricing information databases summarizing and often (z)-16 (-16 (i.h(h)12 (er)-17 (me-12 (s)-11 t-12 (n(t)-12

Transactions with related parties in countries with lower effective/marginal tax rates, especially “secrecy jurisdictions” from which tax information is not likely to be shared;

Local low profit or loss making companies having material cross-border transactions with related parties offshore, where the offshore part of the group is relatively much more profitable;

The existence of centralized supply chain companies in favourable tax jurisdictions i.e. centralized sourcing or marketing companies located in jurisdictions with low-tax 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

C.3.3.7. Risk Assessment Tools

C.3.3.7.1. Some of the more common risk identification and assessment tools include calculation templates for thin capitalization and templates for calculating key ratios relevant to transfer pricing. Such tools are relatively basic, based on quantitative information readily available to non-transfer pricing auditors. This may include, for example, information available from the tax returns and audited financial statements to assist auditors in

C.3.4.2. Supervision of Examination

C.3.4.2.1. A key issue for a tax administration is how to ensure transfer pricing audit approaches are uniform over the whole country. This is especially a pressing problem for a country which has a vast geographical area to cover. An illustration of an effort to solve the “uniformity” problem can be seen from the case of Japan.

C.3.4.2.2. When Japan enacted its transfer pricing tax legislation in 1986, one of the issues was how to administer the transfer pricing legislation 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 the rule was established that prior approval from the Director (Internation(c)-1p dowa tnistion(c)6 (w)()-5 (n)2 (1)-8 (9h)12 (e)-4 ()-110 (t)-6 (h

C.3.4.5. Information Already in Hand

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

C.3.5.2. Understanding the Taxpayers' Business

C.3.5.2.1. Understanding the taxpayer's business operations is an essential part of the transfer pricing examination. This study can be commenced before starting a transfer pricing audit or even after that time, and should include an understanding of the following:

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

C.3.5.2.2. The following may be useful sources for gaining an understanding of the taxpayer's business operations:

- Transfer pricing documentation;
- Annual reports;
- Securities reports;
- Books and other public75ety) ()-10T94 (n)2 (t)-10 i e taxpye syrations;

C.3.5.5. Audit Procedure

C.3.5.5.1. Audit Approach

C.3.5.5.1.1. 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 generally not disclosed to the taxpayer.

C.3.5.5.2. Notification to Taxpayer

C.3.5.5.2.1. 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.

C.3.5.5.2.2. 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.

C.3.5.5.2.3. The examiners will usually suggest a meeting with the taxpayer, where the examiners may discuss the schedule of the t s-10 (s)5 (td (eTw 9.1f-10 (s(e)-16 (r)-17 (p)-20 (r)-17 (i)-12 ce)-16 (i)-12 (n)-10 g(a)25

Information returns: Information returns may be required for transfer pricing purposes.

Name, etc. of Foreign Related Persons	Name Head or Main Office	Business Year or Consolidated Year	Corporation's Name

	Interest on Loan(s) or Borrowing(s)	Receipt	mil.yen	mil.yen	mil.yen
		Payment	mil.yen	mil.yen	mil.yen
		Calculation Method	mil.yen	mil.yen	mil.yen
Existence of APA			Yes No	Yes No	Yes No

C.3.5.5.3.2. 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 a country's taxation law. Furthermore, certain countries have specific statutory provisions for requesting information regarding transfer pricing issues.

C.3.5.5.3.3. It is useful to interview the personnel of the taxpayer engaged in marketing and sales and those in the accounting and financial departments. See Paragraph C.3.5.5.10. for more details.

C.3.5.5.3.4. 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 C.3.5.5.11 for more details.

C.3.5.5.3.5. 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.

C.3.5.5.4. Sources of Information

C.3.5.5.4.1. 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.

C.3.5.5.4.2. 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 light of the domestic law of the country concerned.

C.3.5.5.4.3. 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.⁴ 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

⁴Japanese Special Taxation Measures Law Art. 66-4, Paragraph 8.

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.

C.3.5.5.5. Language

C.3.5.5.5.1. 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 the foreign language documents necessary for transfer pricing audit. If the documents are voluminous the cost of translation is substantial.

C.3.5.5.5.2. When the relevant documents are written in a foreign language the examiners frequently request 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.

C.3.5.5.5.3. If a document necessary for a transfer pricing audit is written in a foreign language and cannot be understood by the examiners, it will generally be the party with the burden of proof that will suffer a disadvantage.

C.3.5.5.5.4. The English language may have a unique position as a foreign language in this context. 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.

C.3.5.5.6.

C.3.5.5.7. Points for Examination at the Initial Stage

C.3.5.5.7.1. In order to correctly ascertain whether any issue 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 by the persons compared:

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;

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;

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.

C.3.5.5.7.2. Prior to the calculation of arm's length prices, examinations should be conducted from different viewpoints in order to determine whether there are any issues regarding transfer pricing and to ensure that the examinations are conducted effectively. The following methods could be used:

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;

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.

C.3.5.5.7.3. Once the transfer pricing audit starts, various aspects of arm's length pricing will be involved and will consume a considerable amount of time. After the above examinations, it may be useful to pause to reflect upon the audit in general. This will occur before starting the calculation of an arm's length value, which will consume the biggest part of the transfer pricing audit resources. The auditor should review whether it is likely that continuing the transfer pricing audit would produce a fruitful result from the viewpoint of efficiency.

C.3.5.5.8. Contemporaneous Documentation

C.3.5.5.8.1. Contemporaneous documentation is explained in detail in Chapter C.2. 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.

C.3.5.5.8.2. 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. Incomplete or inaccurate contemporaneous documentation may provide the examiners with a "road map" for their transfer pricing audit.

C.3.5.5.9. Information Request/Supplemental Information

C.3.5.5.9.1. ~~Other (low) (2) A sample list of information documents to be provided to the IRS and the IRS (9) (1)~~

C.3.5.5.10. Request for Interviews

C.3.5.5.10.1. 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 aspects noted below are pertinent to the taxpayer's responses to the requests for interviews.

C.3.5.5.10.2. 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.

C.3.5.5.10.3. The interviewees should be made familiar with the process and should understand the procedures, purpose and importance of the interview.

C.3.5.5.10.4. Interviews are usually conducted in a cooperative manner. The taxpayer may work with the examination team to agree the rules of the interview by an advance agreement, to avoid confusion. This 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.

C.3.5.5.10.5. If the person to be interviewed is not a native speaker of the language of the interview it is advisab

3. _____ (%)		
--------------	--	--

Principal vendors

C.3.6.3 Refining Functions and Risk Analysis

C.3.6.3.1.

C.3.6.7. Formal Notification to Taxpayer of Proposed Adjustment

C.3.6.7.1. Unless the taxpayer and the examination team can reach agreement, the formal notification of the proposed adjustment will be issued.

C.3.6.7.2. In some 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 other countries this formal notification procedure does not exist.

C.3.6.8. Issuance of Adjustment/Correction

C.3.6.8.1. If the taxpayer does not accept the formal notification of proposed adjustment, a final adjustment (i.e. a notice of deficiency) will be issued. In certain countries this final

C.3.8.2. As an example, the following measures are taken in Japan to protect a taxpayer's pursuit of an APA:

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;

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).

Table C.3. 3: Audit Closure Template

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			

1. AUDIT OBJECTIVE

2. AUDIT SCOPE

3. RISKS IDENTIFIED AT PROFILING AND PLANNING STAGE

9. TAXPAYER CONCURRENCE, RECOMMENDATIONS, OR COMMENDATIONS

