



Policy Statement

Transfer Pricing Documentation: A case for international cooperation

In 1994, only one country had enacted transfer pricing documentation requirements. By 2002, more than 20 countries had done so, and this number is expected to continue to grow. Since about 50% of global exchanges are usually considered as intercompany exchanges, it is legitimate that tax authorities expect taxpayers to document their transfer pricing from both a tax and an economic perspective. However, as transfer pricing is a global issue for multinational enterprises, taxpayers expect in return that tax authorities deal with that issue in a uniform manner that will prevent international double taxation. The ever increasing and diverse documentation requirements are a result of separate and uncoordinated requirements by tax authorities. For taxpayers with international transactions, and in particular multinational enterprises, this leads to an inappropriate, unnecessary and very costly compliance burden.

Large differences between requirements of the countries

Although transfer pricing regulations follow to a large extent the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Authorities (OECD Guidelines) and are more or less similar from one country to another (with some significant exceptions), their implementation by local tax authorities differs greatly. These differences mainly arise from the fact that each tax authority focuses principally on its own local perspective, trying to secure or increase its national tax base, without taking into account the global underlying rationale of tax policy. Presently, taxpayers are expected, from the standpoint of the respective tax authorities, to warrant the highest tax base possible to each and every country where they operate, which leads inevitably to the risk of multiple taxation in the absence of effective treaty competent authority mechanisms.

It is common for tax authorities to deal with the same issues in different ways. Some frequent, non-exhaustive examples of different local treatment of the same issue are:

- capital risk allocation between manufacturer and distributor;
- entrepreneur (risk-taker) function allocation between intangible owner, manufacturer and distributor;
- separation (or non separation) of the capital function from the trading function in financial and non-financial trading operations;
- allocation of the local market penetration risk and rewards;
- separation (or non separation) of intangible compensation from underlying tangible transactions;

- set off between symmetric transactions;
- use of profit methods and related adjustments; and
- remuneration for the use or transfer of intangible property.

Need for a common understanding regarding burden of proof

It is of the utmost importance that a universal consensus on the treatment of these issues is reached. It is, therefore, recommended that the international business community work with the OECD and other international organisations to this end. However, recognizing that such a goal is extremely ambitious and time consuming, significant progress can be achieved with the adoption of a common set of rules in terms of burden of proof, i.e. determining when the taxpayer's position can be considered as reasonable until proven otherwise.

Too many tax authorities take advantage of the lack of specific documentation guidelines from the OECD to reject the taxpayer's approach as inconsistent with local expectations, even when the taxpayer has submitted transfer pricing documentation, consistent with its own global policies. Although most tax authorities admit that valid transfer pricing documentation avoids the reversal of the burden of proof on the taxpayer (in those jurisdictions where the burden lies initially on the tax administration), they do not share a common view on what should be in that documentation. Moreover, the local regulations of the tax authorities do not specify clearly what should be included in such documentation. Even within the European Union, documentation accepted by one member state is often disqualified by another state as irrelevant. The main causes for such local disqualification are e.g.:

- the functional analysis is not detailed enough as far as the local entity is concerned;
- a profits method is used although it is not accepted locally;
- the tested party (i.e. the party tested as operating at arm's length) is a foreign party which does not allow the local tax authority to verify the accuracy of the economic calculations or underlying financial accounts. In other words, the documentation supports that the foreign related party operates at arm's length; however, this does not necessarily prove, according to some tax authorities, that the local party dealing with that foreign party also operates at arm's length.

Need for a common set of rules for documentation

A global set of rules allowing multinational companies to prepare a single set of documentation considered as reasonable by all involved tax authorities should be developed. The implementation of global rules does not mean that tax authorities will be forced to accept the position documented under such rules, but that they would bear the burden of proof if they want to challenge it. Furthermore, any challenge of a position documented under that set of rules, if turned into formal transfer pricing adjustments notified by the tax authority, should give the taxpayer an automatic right to ask for an arbitration procedure, which would provide for a solution that would preclude international double taxation, (at least within the European Union, where such a procedure is already established). In a tax

treaty context, mandatory arbitration should be available where the mutual agreement procedure is not successful.

Possible contents of a single set of documentation

A common set of rules could include the elements of an acceptable documentation for all tax authorities. The acceptance of the documentation package by the tax authorities should be judged in the light of what is readily available in the bookkeeping and management reports of the company concerned. The common documentation rules should not merely cumulate all requirements of all countries, but must represent a reasonable and balanced reflection of the various national approaches. For example, the work of the Pacific Association of Tax Administrations (PATA) is a welcome initiative, but ICC does not regard the PATA proposal as consistent with the objectives set out above. Furthermore, if companies make the effort to fulfil the documentation requirements as described, the taxpayer should be freed from having any special burden of proof, and should not be faced with any penalties. Such a documentation package could be structured according to the outline below.

1. Mapping

A short description of the business and relevant market is expected. Such descriptions are often available in annual reports or other public documents. A separate market study prepared for purposes of the transfer pricing documentation should not be expected or required.

The documentation should track significant inter-company flows that impact the taxpayer. The materiality level should be defined for such reporting.

Economic and legal qualification of these flows should be provided. Flows not impacting the taxpayer for which the documentation is prepared should not be reported, unless the taxpayer decides otherwise.

2. Functional analysis

The functional analysis is a practical analysis serving as a basis for transfer pricing method and economic analysis. Such functional analysis can be fully achieved through a function – risk summary. Taxpayers should not be required to provide a comprehensive economic description of their activities prepared by external consultants, which in any case may be useless from a transfer pricing perspective.

Guidelines could provide an illustration of functions and risks expected to be analysed for transfer pricing purposes. Taxpayers should be free to depart from these guidelines on the basis of a reasonable explanation.

3. Method analysis

All OECD methods should be acceptable if consistent with the functional analysis. Taxpayers should not be expected to support the choice of the best method, but rather that the method selected meets the arm's length standard.

4. Economic analysis

Taxpayers should be free to choose any tested party involved in the documented transfer pricing, as long as the choice is consistent with the requirements of the transfer pricing method selected.

Taxpayers should be free to choose any profit level indicator as long as the choice is consistent with the economic model selected.

A taxpayer's transfer pricing should be allowed to be anywhere in the arm's length range, and not be expected to meet one specific point (such as the median or average).

In the event that tax authorities determine to challenge a taxpayer's transfer pricing or documentation, the Tax Authority must utilize arm's length data that can be fully evaluated by the taxpayer and other tax authorities (so-called secret comparables should not be utilized, consistent with OECD Guidelines paragraph 3.30).

5. Report

Where feasible, the tax authorities should accept documentation in the language in which it has been prepared. However, local language translations may be required if necessary and upon reasonable notice to the taxpayer.

As mentioned in the OECD Guidelines (paragraph 5.15), tax authorities should limit the amount of information that is requested at the stage of filing the tax return. It would be unreasonable to require a full transfer pricing documentation package at such a point in time. Information should be limited to what is necessary for the tax authorities to determine whether a taxpayer needs further examination. It would be reasonable to expect that the documentation includes information on the the main transfer pricing principles followed by the taxpayer.

In case additional documents are requested on examination by a Tax Authority, the taxpayer must be given sufficient time to collect and prepare the documents.

6. Draft documentation package

The ICC Commission on Taxation is in the process of preparing a sample documentation package that it believes will facilitate achievement of the objectives of this policy statement. This package will be released for comment in due course.

*_*_*_*_*_*