

Advanced Unedited Version

Transfer Pricing Compliance Assurance – An End-to-End Toolkit

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1. Foreword

The United Nations Committee of Experts on International Cooperation in Tax Matters (“the Committee”) is globally recognized for its work in norm- and policy-shaping and for the guidance it provides in the area of international tax cooperation. It generates practical guidance for governments, tax administrators and taxpayers to help strengthen tax systems, with a view to mobilize financing for sustainable development.

Through its work, the Committee aims to prevent “double (or multiple) taxation” and “non-taxation” and assist countries to broaden their tax base, strengthen their tax administrations and to curb international tax evasion and avoidance. In all of its work, the Committee gives special focus to least developed countries and others in special situations, including small island states and landlocked countries.

The Committee is a subsidiary body of the UN’s Economic and Social Council. It is comprised of twenty-five members nominated by Governments and acting in their expert capacity, drawn from the fields of tax policy and tax administration and selected to reflect an adequate equitable geographical distribution, representing different tax systems. The current membership was appointed by the Secretary-General, after notification was given to the Economic and Social Council, for a four-year term starting on 1 July 2021 and ending on 30 June 2025.

During its 23rd Session in 2021, the Committee decided to continue its work on transfer pricing given the relevance of intragroup trade and its potential impact on corporate income taxes. To this end, the Committee formed a Subcommittee on Transfer Pricing (“the Subcommittee”).

The Committee mandated the Subcommittee to consider, report on and propose guidance on transfer pricing issues, on the basis:

- That it reflects article 9 of the United Nations Model Convention, and the arm’s length principle embodied in it, and be consistent with relevant commentaries of the United Nations Model Convention;
- That the Subcommittee identify and consider the transfer pricing topics where guidance from the Committees was the most useful;
- That it reflects the realities for, and the needs of, developing countries, at their relevant stages of capacity development; and
- That it gives due consideration to relevant work in other forums, including the Inclusive Framework on Base Erosion and Profit Shifting, and may consult broadly.

During the 24th Session of the Committee, the Committee approved the Subcommittee’s ambitious work plan, consisting of interstitial guidance on the following topics:

- Transfer Pricing during the COVID-19 Economic Downturn
- Transfer Pricing Compliance Assurance – An End-to-End Toolkit
- Transfer Pricing of Carbon Offsets and Carbon Credits
- Transfer Pricing Aspects of Agricultural Products
- Transfer Pricing in the Pharmaceutical Industry

- Dispute Avoidance and Bilateral Advance Pricing Agreement / Arrangement Programmes

The guidance at hand is on “Transfer Pricing Compliance Assurance – An End-to-End Toolkit”.

The specific topics were chosen for their practical relevance and development focus, based on feedback from former participants of capacity development workshops in the area of transfer pricing.

By its 28th Session, the Committee had reviewed, refined, finalized and approved guidance on all of the above transfer pricing topics. It sought throughout to prepare products that assist all stakeholders, especially officials in developing countries, in dealing with the issues covered. The guidance products should also assist in making capacity development activities as practical, targeted and effective as possible.

The Subcommittee met productively on many occasions – predominantly virtually as well as in hybrid format in Vienna in 2023 and 2024. The generosity of the Austrian government and the Vienna University of Economics and Business is warmly acknowledged, as are the generous financial contributions from Denmark, the European Commission, India, Norway and Sweden to UN DESA’s multi-donor project to provide strengthened substantive and logistical support to the work of the Committee, its subcommittees and related capacity development activities.

The Subcommittee is comprised of participants from tax administrations and policy-makers with wide and varied experience in dealing with transfer pricing, as well as from academia, international organizations and the private sector, including from multinational enterprises and advisers.

The participants of the Subcommittee and their countries (in the case of government officials) or current affiliations (in other cases) bearing in mind that membership is in a personal capacity, contributing to the guidance were the following: Ingela Willfors (Sweden— Co-Coordinator); Mathew Gbonjubola (Nigeria —Co-Coordinator); Matthew Andrew (Auckland University, New Zealand); Rajat Bansal (India); Melinda Brown (OECD); Rasmi Das (India); Barbara Dooley (Ireland); Lorraine Eden (Texas A&M University, USA); Mauro Faggion (European Commission); Björn Heidecke (Deloitte, Germany); Michael Kobetsky (Australian National University, Australia); Wazi Ligomeka (Malawi); Luis María Mendez (Argentina); Pande Oka Kusumawardani (Indonesia); Nana Mensah Otoo (Ghana); T.P. Ostwal (T.P. Ostwal & Associates LLP, India); El Hadramy Oubeid (Mauritania); Raffaele Petruzzi (WU Transfer Pricing Center, Institute for Austrian and International Tax Law, Vienna University of Economics and Business, Austria); Claudia Pimentel (Brazil); David Rüll (Germany); Jolanda Schenk (Shell, Netherlands); Ruchika Sharma (India); Stig Sollund (independent consultant, Norway); Trude Steinnes Sønvisen (Norway); José Troya González (CPA - Robalino, Ecuador); Monique van Herksen (Simmons & Simmons, Netherlands); Marcos Valadão (Getulio Vargas Foundation, Brazil); Yan Xiong (China). The early involvement of Carlos Perez-Gomez Serrano (KPMG, Mexico) and Anthony Munanda (ATAF) is also recognized. The assistance of the Secretariat, including especially Ilka Ritter and Michael Lennard in this work is gratefully acknowledged.

2. Introduction

This Toolkit is intended to provide tools and examples of good practices to support efficient and effective transfer pricing compliance assurance, with an emphasis on the priorities and needs of developing and capacity constrained countries. As such, it is aimed primarily at tax administrations of developing countries that have transfer pricing rules in place. It also assumes that the country's corporate income tax system is primarily based on self-assessment, with audits and assessments carried out by the tax administration only in certain circumstances.

All tax administrations, but particularly those from developing countries, face resource and capacity constraints. This is often particularly acute in a specialized (and often relatively newly introduced) area such as transfer pricing. This makes it especially important to ensure that limited resources are targeted as efficiently and effectively as possible. Applying focused, risk-based approaches to ensuring compliance can help to ensure this goal is met.

This Toolkit discusses the development of an end-to-end transfer pricing compliance assurance programme, encompassing population and individual taxpayer-level risk assessment and comprehensive audits or examinations. Associated issues such as incorporating feedback loops to validate and ensure continuous improvement of the programme are also discussed. While the practicalities of undertaking transfer pricing risk assessments and audits are the main focus of this Toolkit, by putting these into the context of a holistic, end-to-end process, the aim is to help ensure a systematic review of the tax environment, to minimize potential gaps in both information and revenues, and to reinforce an overall goal of optimizing compliance and sound tax administration.

The Toolkit also aims to encourage greater alignment and exchange of good practices in transfer pricing risk assessment and audit, with the goal of reducing transfer pricing disputes which can be costly and time consuming for all parties concerned.

The remainder of this introductory section sets out the objectives of the Toolkit, then discusses the purpose of transfer pricing compliance assurance programmes by tax administrations, and concludes by providing an initial overview of such programmes. Section 3 continues this by providing a more in-depth discussion of the end-to-end transfer pricing compliance assurance process: starting from the development of specific compliance objectives and tools and concluding with an introduction to individual transfer pricing risk assessments and audits. Sections 4 and 5 then provide detailed, practical roadmaps to guide the process of transfer pricing risk assessments and audits.

2.1 Objectives of this Toolkit

This Toolkit aims to provide guidance, examples, and options tailored to the priorities and needs of developing country tax administrations to develop their own end-to-end processes for compliance assurance on transfer pricing.

Starting with a discussion of transfer pricing compliance assurance programmes overall, it includes (in Sections 4 and 5) roadmaps which set out, in detail, the processes for individual

taxpayer transfer pricing risk assessments and comprehensive transfer pricing audits or examinations. These are intended to be a tool or template from which countries can develop their own processes, manuals, or standard operating procedures, tailored to their specific priorities, needs, and capacities. These sections also include references to processes developed by a number of tax administrations around the world, as well as recommendations or suggested approaches developed by international or regional organizations.

It should be noted that particular processes or tools illustrated or referenced in this Toolkit may not be suitable in all cases. Country examples were developed to meet the needs and fit the particularities, including, importantly, the specific requirements of the domestic transfer pricing, income tax, and administrative tax law and regulations of that country. However, the Toolkit aims to provide options, considerations, and perhaps inspiration for countries to develop their own processes and tools tailored to their particular priorities, requirements, and constraints.

There are many existing sources of guidance on transfer pricing risk assessment and audit.¹ For example, a discussion of transfer pricing risk assessment is included in the UN Practical Manual on Transfer Pricing for Developing Countries (2021) (UN TP Manual) in Chapters 13 (on risk assessment) and 14 (on audit). This Toolkit does not attempt to re-interpret these sources of guidance, but instead, may be helpful as a source book which brings together and points to other sources of guidance where appropriate. The approach taken in Sections 4 and 5 illustrate this approach whereby other sources of guidance and examples from a number of country practices are referred to. Together these sources can serve as a template to help countries develop and tailor their own transfer pricing compliance programmes and processes.

By describing such good practices, this Toolkit may also encourage greater alignment of transfer pricing risk assessment and audit approaches around the world, which may in turn, prevent and help to resolve disputes and double taxation.²

2.2 Purpose of compliance assurance programmes by tax administrations

Transfer pricing compliance assurance programmes can be used by a tax administration to help structure and guide their transfer pricing compliance activities. Each country will have its own priorities and objectives in instituting such a programme, but in general, the overall aim of a compliance programme will be to optimize compliance. This would include preventing and reducing revenue leakage from abusive or incorrect transfer pricing arrangements, preventing and reducing costly and time-consuming transfer pricing disputes, and fostering a sound investment climate, all while maximizing the efficiency and effectiveness of scarce resources needed to manage the tax system.

¹ See, for example: ATAF (2023). Suggested Approach to Tax Audit Preparation and Execution. Available from [ATAF Admin \(ataftax.org\)](https://ataftax.org) as well as CIAT (2019). Cocktail of measures for the control of harmful transfer pricing manipulation, focused in the context of low income and developing countries. Available from https://www.ciat.org/Biblioteca/Estudios/2019_cocktail_TP_ciat_giz.pdf

² See also United Nations (2021). Handbook on Dispute Avoidance and Resolution. Available from [United Nations Handbook on Dispute Avoidance and Resolution | UN DESA Publications](https://www.un.org/development/desa/pubs/2021/04/handbook-on-dispute-avoidance-and-resolution/)

In self-assessment tax systems, encouraging and supporting voluntary compliance is essential as a tax administration is unlikely to have the resources available to audit its way to compliance. While audits and compliance enforcement activities may always be required, ideally these resource-intensive means would only be needed in a small minority of cases. Setting out the tax administration's expectations of taxpayer behaviour and transfer pricing outcomes can help to encourage those taxpayers that are willing to comply, to do so voluntarily, without (significant) additional intervention by the tax administration. This kind of approach would need to be backed by strong, credible enforcement activities, where appropriate, to act as the "stick" to complement the "carrot" of supported voluntary compliance.

Risk assessments and audits form the main components of the 'detect, deter, and address' part of the overall compliance assurance strategy. Effective risk assessment aims at detecting risks to the revenue. Credible, visible compliance activities, both in the form of risk assessments and audits may help to deter taxpayers from engaging in aggressive or opportunistic transfer pricing; and robust and thorough audits aim to address revenue leakage that may otherwise result from incorrect or abusive transfer pricing arrangements.

Risk assessment also aims to ensure that scarce audit and examination resources are used most efficiently and effectively, in tackling the areas of highest or most consequential risk. The level or consequence of risks can be measured in various ways. For example, risks may be large, but 'one-off' or they may involve smaller amounts but may be commonly encountered. A risk may also be considered highly consequential if it is emerging, that is, it may be trending upwards or involve a relatively small amount or number of taxpayers now, but is likely to expand if left "untreated". The nature of the risk involved will impact upon how it should be addressed.

Efficient and effective deployment of transfer pricing compliance resources is essential for all tax administrations but may be critical in ensuring effective law enforcement in resource-constrained developing countries with limited transfer pricing capacity. Transfer pricing audits or examinations are, by nature, highly fact-intensive, and so will often require considerable resources, not only in the audit phase itself, but also in resolving any disputes and double taxation that may arise as the result of an audit adjustment.

Moreover, focusing on compliance resources appropriately can help to build the credibility of the tax administration in the eyes of the taxpayer community. This may be particularly important for tax administrations at or near the start of their transfer pricing journeys when the need to build credibility is greatest. In this respect, case selection for audit, and even more importantly, case selection for pursuit via judicial processes can be critical since these will have the greatest visibility. In such cases, there is an argument to be made for selecting "low-hanging fruit," that is cases where the tax administration is confident of success, for initial compliance enforcement treatment, even where such cases may not represent the largest amount of revenue at stake.³ In all cases, the focusing of compliance resources can benefit

³ See also the description of a "transactional approach" to selecting cases for risk assessment in the UN TP Manual in Section 13.2.3.3 *et seq.*

from considering the balance between cost-benefit and the intersection between risk magnitude-likelihood.

Even for more experienced tax administrations, ensuring that transfer pricing audits are well-chosen and adequately resourced can significantly amplify their compliance effect. Put another way, if compliance resources are not well focused or are inadequate, with the result that audit adjustments are ultimately dropped or fail in court, the credibility of the tax administration to effectively enforce transfer pricing laws where required may be reduced. This could result in reducing the effectiveness of the compliance programme to deter abusive or aggressive transfer pricing arrangements and to encourage voluntary compliance.

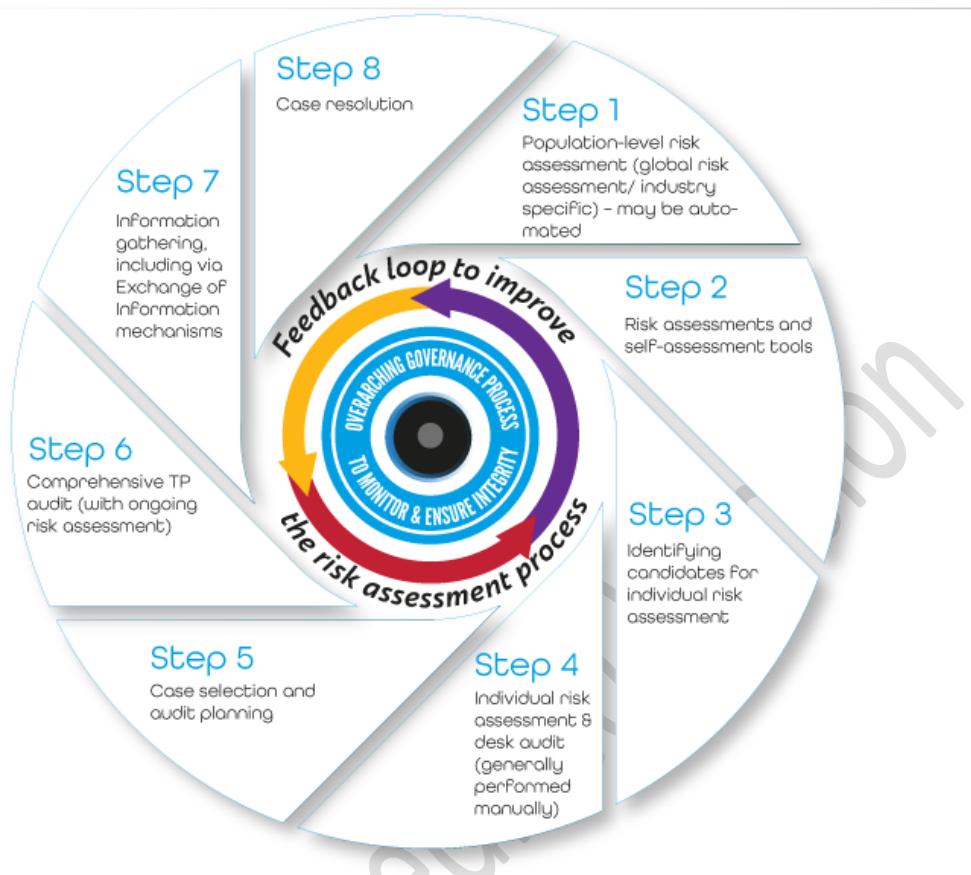
It may also be beneficial for the tax administration to develop additional self-assessment tools for taxpayers to minimize the need for compliance activities in relation to those taxpayers that are willing and able to comply without additional intervention. These kinds of tools are more commonly used by tax administrations with longer experience in transfer pricing and with long-running transfer pricing activities, but could be usefully deployed by less experienced administrations as well.

While greater transparency by tax administrations can support voluntary compliance, a balance needs to be struck to ensure that the information provided cannot be used by less scrupulous taxpayers to create tax planning opportunities. This balance point will vary depending on a number of factors, including, in particular, the level of credibility of the tax administration to appropriately detect and address transfer pricing and other base erosion and profit shifting behaviours, and related to this, the level of trust between taxpayers and the tax administration.

2.3 Introduction to the end-to-end compliance assurance process

An effective end-to-end transfer pricing compliance assurance programme will include a range of elements as illustrated in figure 1 below. These range from high-level risk assessment to a 'long list' case selection, and refining the case selection to a 'short list' for individual risk assessment. From here, the short list is further considered and refined to produce a list of priorities for more comprehensive transfer pricing audits or examinations. A transfer pricing compliance programme may also include self-assessment tools or other forms of guidance for taxpayers designed to encourage and facilitate voluntary compliance. The final element of an effective compliance programme is to ensure there is continuous improvement, including in the form of a feedback loop to verify and improve risk flags following further investigation. Each of these elements is discussed in more detail in Section 3.

Figure 1.0: Transfer Pricing End-to-end Compliance Assurance process



In terms of the inter-relationships between the various parts of the programme, risk assessment is a key element of an efficient, modern tax administration which helps to ensure audits are targeted appropriately to optimize their compliance effects. Without them, audits will often be arbitrary or indiscriminate with the result that they are far more likely to waste compliance resources. They may even have counter-productive effects on tax morale, if for instance, careful taxpayers who take a conservative approach face audits at a similar rate to those who are far more aggressive or unscrupulous.

This Toolkit assumes the existence of sufficient and sound legislation and related rules requiring transfer pricing documentation, including country-by-country reporting. Such requirements are key to unlocking the benefits of risk assessment by allowing the tax administration to have access to much of the information necessary for effective risk assessment. While a discussion of legislation requiring TP documentation is beyond the scope of this Toolkit, guidance on these matters is available elsewhere, including in the UN TP Manual.

At the outset, it will be important for a tax administration to consider the strategy and specific objectives of their transfer pricing compliance assurance programme as this may affect the mix of elements to be included or prioritized. For instance, an administration at or near the start of its transfer pricing journey may wish to include more taxpayer education elements, complemented by highly targeted audits. Alternatively, transfer pricing audits may be conducted as part of broader tax audits, where transfer pricing has been identified as a

particular risk. The targeting of such audits, or the inclusion of transfer pricing as an issue of concern in a general audit should be guided by effective risk assessment, which in itself should be informed by factors such as the nature of the local economy as well as broader policy goals and objectives. For instance, if a country has a significant and high-profile mining industry and transfer pricing is identified as a risk in that industry, for example due to significant cross-border investment in the sector, it may be appropriate for a compliance programme to include a particular focus on risks within that industry as a way of signaling the importance of transfer pricing compliance to taxpayers in all industries.

While this Toolkit necessarily separates the discussion of risk assessment from audits or examinations, the point at which an audit officially commences will vary according to the laws and practices of each country. On the other hand, risk assessments, or a risk assessment mindset, may in fact continue even once an audit has officially commenced. That is, if the tax administration finds that in fact the identified risk can be adequately explained, or that the case is likely to require resources that are disproportionate to the size of the unexplained risk, then the best use of resources would be to close the case, and record the learnings from the experience in order to improve case selection processes going forward. In such cases, pursuing a case solely because resources have already been invested in it, may not be a good approach. Given limited resources, doing so necessarily means other potential risks may not be addressed as a result.

3. End-to-end transfer pricing compliance assurance process – overview

This Section will provide definitions of the main terms and concepts. It will describe in general terms the content and aim of a risk assessment and an audit process. In addition, it will provide an overview of risk assessment tools, including published risk assessment tools designed to encourage voluntary compliance (e.g., “traffic lights” for taxpayers to self-assess or estimate their risk of TP compliance action).

3.1 Objectives / aims of a transfer pricing compliance assurance programme

As noted in Section 2, transfer pricing compliance assurance programmes can have a range of objectives or priorities. However, generally, their aim is to optimize compliance through encouraging voluntary compliance; identifying risks; and deploying compliance resources in a focused and efficient way to address, and where necessary, enforce compliance with the law.

The risk of profit shifting via transfer pricing is ever-present and may come in a variety of forms, from inadvertent errors in pricing to aggressive, calculated tax planning and avoidance, to deliberate fraud and evasion. Different parts of the compliance programme can be used to address these forms with differentiated treatment options. For instance, the programme may include an advisory component and self-assessment tools to assist taxpayers that are willing to comply, providing compliance assurance with a ‘light touch’ for those taxpayers. At the same time, robust risk assessment processes should help detect remaining material transfer pricing risks, which can then be addressed through follow-up compliance activity. In some cases, the risk assessment itself can be a useful tool, serving as a warning to taxpayers and discouraging overly aggressive arrangements. In more serious or significant cases, the application of a comprehensive transfer pricing audit or examination to enforce compliance will be necessary.

While it is beyond the scope of this Toolkit to enter into a thorough discussion of penalties that may be associated with transfer pricing adjustments, the level of penalty applied can also be a useful complementary tool in steering taxpayer behavior.

The specific objectives of a transfer pricing compliance assurance programme are likely to vary by country and over time. For instance, a programme may have a particular focus on certain types of transactions that have been identified as risky or as an emerging risk to be ‘nipped in the bud’. These risks or emerging risks are likely to be dynamic and may change over time, including in response to the success of the compliance programme itself, or to changes in the tax environment. A tax administration may also prioritize certain industries, counterparty jurisdictions, or transaction types, based on a combination of the likely risk to the revenue, and available capacity and resources.

Changes in tax laws both domestically and in other jurisdictions may also prompt particular areas of focus in a programme, for instance, the introduction of special tax regimes or changes in the treatment of interest deductions may result in greater anticipated pressure on certain

types of related party transactions. Changes in other aspects of the trade or regulatory environment may also have similar flow-on effects for tax.

Changes in industry conditions, including general industry performance and level of competition may also be relevant both in terms of setting overall compliance assurance objectives, and perhaps even more importantly, in evaluating and interpreting population level and individual level risk flags.

All of these factors mean that in order to establish suitable objectives and targets for a transfer pricing compliance programme, it will be important to ensure adequate monitoring and intelligence gathering to detect and predict significant or emerging risks.

3.2 Developing a transfer pricing compliance assurance programme

In addition to the qualitative aspects discussed above, trends or anomalies in data may also be useful for identifying compliance risk priorities. For instance, if a revenue trend involving disclosed income or certain types of payments suddenly changes course, or shows a trend that cannot be readily explained, this may indicate that further investigation is warranted. Ongoing monitoring of available data will help to identify such trends and anomalies. Importantly, the data available to the tax administration to carry out such monitoring will not be limited to trends in corporate income tax. Other sources of intelligence may include data on withholding taxes, data on commodity price trends, information on imports and exports from customs and other kinds of indirect taxes, and information from other government regulatory bodies such as those that monitor foreign exchange transactions, etc.

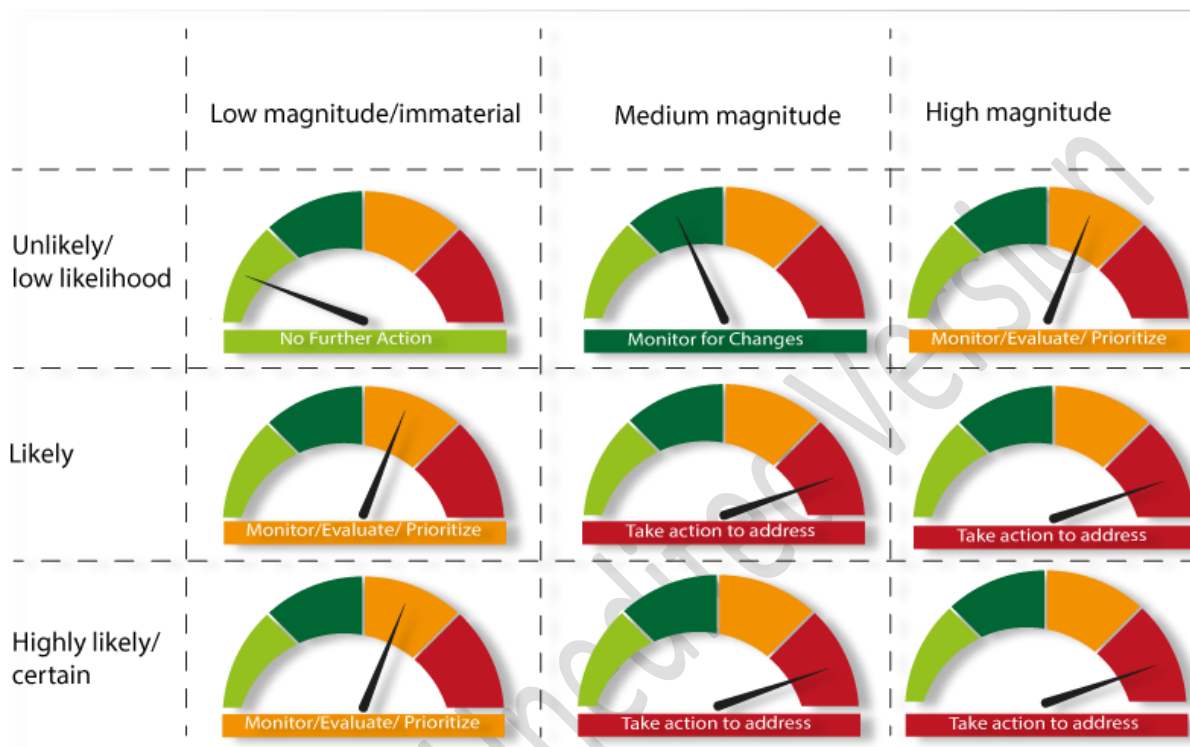
Once a tax administration has identified what kinds of transactions, behaviors, or outcomes it wishes to focus on, it will need to analyze how best to detect those transactions, behaviors, or outcomes from the data it has available to it. In addition to data from tax returns and other sources noted above, more granular and transfer pricing specific data may often be found in the associated and complementary data from filed schedules or information returns and country-by-country reports (CbC reports). Analysts will need to consider how the transactions or behaviors are likely to manifest in the available data. For example, if transactions with certain jurisdictions (e.g., those with low tax rates, creating a significant tax rate differential) are targeted, the CbC report may provide useful information on the multinational enterprise group's presence in those jurisdictions.

This kind of high-level risk assessment, based largely or solely on quantitative information, can often be automated, particularly once initial focus areas and risk flags have been identified. Where available, data mining and machine learning tools can be used to analyze available data and may be effectively deployed to spot emerging trends, outliers, and anomalies in such data.

The next step in the process will generally be to refine the long list of potential targets through manual analysis. In prioritizing potential risks for further action, the magnitude as well as the likelihood of the risk(s) may need to be considered (see Box 1). Other relevant factors may include whether the potential risk is likely to expand or have knock-on effects if not addressed

promptly, and the visibility of the risk or the taxpayers involved. This can be particularly important to maintaining taxpayer morale. In some cases, other overall priorities identified by the administration, including those based on available capacity and resources, may also be relevant.

Box 1: Risk Magnitude / Likelihood Matrix



3.3 Transfer pricing risk assessments and related tools

It may be appropriate to keep certain risk flags or specific indicators of risk confidential in order to prevent taxpayers from masking such indicators to evade detection. However, in some cases, tax administrations may consider publishing information about their compliance priorities or some of their risk flags, particularly as regards to the types of arrangements, behaviors, or outcomes that they consider to be problematic. This can provide guidance for taxpayers that are willing to comply, putting them on notice that such arrangements, behaviors, or outcomes are likely to attract the attention of the tax administration, and with the aim that they may either choose to avoid these or at a minimum, that they would be on notice to take particular care in documenting thereof. Such information can also serve as, or complement, taxpayer information, or educational material.

In some cases, tax administrations may choose to set out this kind of information in detail in the form of an administrative safe harbour. In other cases, it may take the form of a self-assessment tool that can be used by taxpayers. For example, some administrations publish compliance guidelines which set out in detail a range of results that the tax administration

regards as low / medium / high risk for a particular type of activity or transaction.⁴ In such cases, the guideline would need to specify the scoping criteria to which the guidance applies carefully. The ranges specified would also need to be calibrated with care. A “low risk” range that is too generous is likely to become irrelevant; too far in the other direction and it may not in fact represent a “low risk” outcome. Graded or ‘traffic light’ approaches which use multiple ranges (green, low risk zone; amber, moderate risk zone; and red, high-risk zone) would allow for greater nuance in the approach than the nomination of a single range / point.

Similarly, some jurisdictions may also choose to apply safe harbours to certain types of transactions, in order to simplify and reduce compliance and administrative burdens. Where such safe harbours exist (either in law / regulation or in the form of administrative guidance), they should inform the risk assessment process. That is, where transactions fall within a transfer pricing safe harbour, they should be excluded from further compliance action in relation to the transfer pricing.

3.4 Population level and individual transfer pricing risk assessments

A number of processes are available to guide the selection of cases for individual transfer pricing risk assessments. For instance, the UN TP Manual describes three approaches: a transactional approach, which focuses on particular transaction types (perhaps “easier” transactions, or higher risk / higher revenue transactions); a jurisdictional approach, which directs compliance resources based on the identity of the counterparty jurisdiction; or a risk-based approach, which may combine elements of both.⁵ This Toolkit focuses on the risk-based approach, but it is important to note that transactional and jurisdictional approaches can also be accommodated within the framework described in this Toolkit by simply identifying particular transaction types or jurisdictions as risk flags.

In many cases, tax administrations may find it useful to apply an iterative approach to risk-based case selection whereby initially, population-level filters or risk flags are applied to determine a ‘long-list’ of possible risks / case candidates, which are then further refined (possibly more than once) to a ‘short-list’ of possible risks / case candidates. Through such processes, a combination of processes may also be used. For instance, if a risk-based long-list results in a significant number of potential cases involving a particular jurisdiction, it may make sense to undertake an additional process based on a jurisdictional approach in order to determine a short list of potential cases to be addressed via a specific project. Taking a project approach such as this allows for greater efficiency since an understanding of relevant features of the other jurisdiction could be applied across a number of similar cases.

Risk flags can be identified through population level or industry level data monitoring, intelligence from compliance field officers or other spontaneous sources, and / or a random selection. In many cases, a combination of factors may be used to determine a ‘long list’ of taxpayers for individual risk assessment.

⁴ Where specific results are provided for in such guidance, tax administrations need to consider the extent to which such results will become *de facto* safe harbours.

⁵ See UN TP Manual, Chapter 13 from Section 13.2.3.3 *et seq*

Potential cases identified through risk flags in automated or centralized data monitoring may first undergo an initial screening process. In some cases, such additional screening, particularly if conducted by an analyst with a sound understanding of the industry in which the taxpayer operates, may be able to account for the presence of the risk flags and provide assurance that the risk of inappropriate transfer pricing is in fact low. The case may then be subject to a monitoring brief (i.e., for further analysis and checking next year, or as a lower priority for examination), or may be dismissed altogether and returned to the general population pool with no special focus.

Potential cases identified through receipt of intelligence, including through exchange of information, may also benefit from some level of additional screening, but will often warrant further examination through an individual risk assessment.

In some tax administrations, processes include adding cases to the 'long list' based on random selection. Such inclusions can be useful as an integrity measure and to help verify and validate identified risk flags to ensure they are not missing significant risks.

Risk assessments at a population of industry / segment level can be used to effectively target more detailed and in-depth individual risk assessments. The first stage of such an assessment will typically use only data already available to the tax administration analyst, such as tax return and associated information, transfer pricing documentation (where routinely filed), and the CbC report where available, together with publicly available information on the taxpayer and its industry.

The individual-level risk assessment, done manually by an analyst with a sound knowledge of transfer pricing principles, focuses on the question of whether the identified risks can likely be adequately explained by known commercial or non-tax factors. For example, a risk flag thrown up by a reduction in profitability may be (partially) explained by a known commercial event, such as a downturn in the industry. Risk flags may have been thrown up by an error in the data set. If such errors are discovered, the risk flag may be able to be dismissed at this point.

The risk analyst should focus on the risk hypothesis posed by the risk flag, and test this against the other information known about the taxpayer (e.g., level of related and unrelated party sales, related and unrelated party sales prices / discounts, gross margins, etc.). Risk flags may be raised based on certain types of transactions being undertaken, certain financial ratios, or mismatches / misalignments in the information available from different sources. In some cases, it may be possible to dismiss certain risk flags based on publicly available information and closer examination of information already in the hands of the tax administration.

To this point, the tax administration may not have had any direct contact with the taxpayer and may not have notified the taxpayer that they are subject to a risk assessment. If, based on information already available to the tax administration, risk flags cannot be discounted, a decision will need to be made on whether the risk is such that further analysis and compliance activities should be undertaken. Once again, the magnitude / likelihood matrix may be useful here, as well as risk scoring models that seek to combine various risks and allow a comparison

of the relative risk to the revenue from various potential cases, along with likely resource cost involved in pursuing the case.

If further analysis is indeed warranted, the next step may be to undertake a more rigorous individual risk assessment, sometimes called a 'desk audit' which may include seeking specific information from the taxpayer themselves. Where transfer pricing documentation (e.g., master file and local file) is not required to be filed annually, but instead made available on request, such documentation will generally be sought and considered by the analyst. The analyst would examine the qualitative information available in the TP documentation package, including setting out a summary (draft) functional analysis. This could then be compared to expected arm's length outcomes for similar types of activities, perhaps based on industry averages. It should be stressed that at this stage, this cannot be described as a comparability analysis as the industry averages used may not indeed be truly comparable. However, such approximate results may give sufficient indication as to the level of risk.

In considering the level of risk posed by the transactions or arrangement concerned, the analyst may also find it useful to consider the taxpayer's apparent appetite for risk more broadly, based on other information including their history with the tax administration (including as it may relate to other taxes) and regulatory bodies. Other indicators of taxpayer behaviour and their willingness to comply may also be relevant. For example, a taxpayer who is found to have no, or grossly inadequate, transfer pricing documentation is likely to pose a greater risk than one who diligently analyzes and records its transfer pricing processes.

3.5 Governance of risk assessment

Throughout the risk assessment process, it is important to ensure adequate governance mechanisms are in place to ensure quality control, consistency, and the integrity of the process. In many administrations, an important component of the governance process may take the form of case reviews undertaken at various milestones (and in some cases randomly). For instance, at the end of the individual risk assessment process, a central committee review may be conducted to confirm the recommendation of the analyst regarding the outcome and status of the case (e.g., high / medium / low priority audit / monitoring brief /no further action). Since prioritization will necessarily require comparing risks, and thus, potential cases for audits across the administration, a primary objective of such a centralized process is to ensure appropriate calibration of risk outcomes and resource allocation across the jurisdiction.

At the end of the formal risk assessment phase, it may be helpful to produce a brief report on the process to help feed back into improving the risk assessment process. This is particularly important where the outcome of this phase is for a monitoring brief, as this implies, that the case should be re-examined in the following period. Similarly, for cases where no further action is to be taken, as this indicates, that the initial quantitative risk flags threw up a false positive and may benefit from additional consideration or calibration.

The efficacy and effectiveness of the risk assessment processes used should be reviewed periodically in order to ensure that they remain appropriate, and consider where improvements could be made.

Box 2: Summary of Transfer Pricing Risk Assessment Processes



Source: based on UN TP Manual in Section 13.2.6.2

3.6 Comprehensive transfer pricing audit / examination

3.6.1 Risk assessments and audits

The line between a risk assessment and an audit or examination varies. In some cases, the distinction can be an important one in terms of process as once an audit commences there may be specific requirements around timing, both for intermediate steps in the process and the final conclusion of the audit, as well as expectations or requirements around taxpayer cooperation, etc. While the distinction between the formal risk assessment and an audit can be important, a risk assessment mindset should continue even once an audit or examination is opened in order to ensure continued efficiency in the use of compliance resources. That is, if after commencing the audit phase, it is determined that the identified risk can be adequately explained, or there is little likelihood of supporting a material adjustment, then the audit should be closed without delay so that compliance resources can be re-deployed more effectively.

3.6.2 Audit case selection and allocation

The risk assessment process described earlier aims to produce a prioritized list of audit candidates. Once these have been confirmed through a review process, the cases can be allocated according to priority and available resources. How cases are prioritized and allocated will vary depending on the resources available. For example, in many countries, an industry approach has proven to be useful, allowing audit teams to gain experience and expertise in an industry, something that can be critical to successful and efficient transfer pricing analyses. As has been noted above, transfer pricing audits are fact-intensive, and to ensure processes are robust and credible, it will be important that audit teams are sufficiently well-resourced and have access to the necessary expertise. This may mean that resource-constrained administrations prioritize conducting fewer transfer pricing audits well over a greater number of audits done superficially.

3.6.3 Audit process

It can be good practice for the audit team to set out an audit plan, specifying the audit hypothesis, and then work towards gathering evidence to support (or reject) that hypothesis. Having regard to the requirements of evidence is good practice and may be useful even in cases that will not ultimately rely on a judicial process. This may impact how information is requested from the taxpayer, as well as the type and rigour of the information gathering and recording process. For instance, it can be useful to confirm a summary of the facts upon which the functional analysis is based with the taxpayer so that the facts themselves are not in dispute (even if the taxpayer may have a different interpretation of those facts and their impact on the appropriate transfer pricing).

A robust and thorough functional analysis will generally benefit from on-site interviews with key personnel, and an inspection of the taxpayer's premises, where this is feasible. From the functional analysis, together with a consideration of the other economically relevant characteristics, the process of accurately delineating the transaction(s), determining the most

appropriate method, and conducting a comparability analysis may involve a certain amount of iteration, testing a particular hypothesis against the available information in order to arrive at the most appropriate and reliable arm's length outcome. As is discussed in the Toolkit on *Addressing Difficulties in Accessing Comparables Data for Transfer Pricing Analyses*,⁶ while perfect comparables are generally elusive, the most critical aspect of a transfer pricing analysis is often ensuring an accurate delineation of the tested transaction(s), since this is what determines the most appropriate method and forms the foundation for the search for comparables.

As with the risk assessment part of the compliance assurance process, it is important to ensure robust governance mechanisms are in place to support the audit function. In many countries, this may be achieved through having a central review process at particular milestones during the audit, for example prior to the finalization of an interim or final position paper. Such a review process should aim to ensure consistency and provide quality assurance, as well as acting as an integrity mechanism overseeing the audit function.

3.6.4 *Post-audit processes*

The final stage of the audit will involve reporting on outcomes and considering learnings and recommendations to improve the compliance assurance process. Findings from the audit can also be very useful in calibrating and verifying the risk assessment process and in directing the areas of focus for the compliance assurance programme more broadly.

Information about the nature of the industry and commercial practice therein can also be useful intelligence for future audit teams and should be recorded and accessible within the tax administration. Taxpayer confidentiality is likely to be relevant here, so a redacted or anonymized report that can be more widely shared within the tax administration may be useful in this regard, perhaps combined with more sensitive information in files shared only with officials on a need-to-know basis.

The below figure summarizes the transfer pricing audit / examination process.

⁶ Platform for Collaboration on Tax (2017). Toolkit for addressing difficulties in accessing comparables data for transfer pricing analyses. Available from <https://www.tax-platform.org/publications>

Box 3: Summary of Transfer Pricing Audit/ Examination Processes



Source: Based on Chapter 14 of the UN TP Manual

3.7 Validation / continuous improvement of the transfer pricing compliance assurance programme

An important final step in the development of a transfer pricing compliance assurance programme is to ensure an appropriate and adequate feedback loop to continuously validate and improve the programme. In this respect, information and intelligence gathered through the risk assessment and audit phases may be useful in identifying newly emerging potential risks or trends, or alternatively in explaining factors erroneously identified as risk flags in the past.

Learnings from risk assessments and audits should also feed into the processes for conducting examinations themselves, as well as associated objections, appeal, and settlement resolution processes. In some cases, learnings from audit and examination processes may even prompt legislative, regulatory, or administrative reforms. These may have the aim of closing loopholes; strengthening administrative procedures / instituting more robust procedures; or providing more helpful guidance to taxpayers. Feedback mechanisms from audit teams to other parts of the tax administration and the government responsible for tax policy are, therefore, important.

Learnings from transfer pricing audit or examination cases may also be useful in capacity building. This is particularly true of industry and commercial knowledge that may be gained by officials conducting the transfer pricing audit. As noted above, many tax administrations thus find it useful to take an industry or topic specialization approach in order to help build experience and expertise in key industry sectors or in relation to particular types of transactions or arrangements. In order to retain this institutional knowledge, it can be helpful for tax administrations to put in place formal case learning processes whereby at the close of a case, the officers involved record or present key findings to a broader audience and ensure useful information about the industry or transaction type can be found by other officers in the future.

4. Road map for transfer pricing risk assessment

The aim of this Section is to provide a guide to good practices and processes to assist with the planning, execution, and resolution of transfer pricing risk assessment.

4.1 Organizational matters of a transfer pricing compliance programme

Tax administrations organize themselves in different ways to conduct risk assessments. An effective transfer pricing compliance programme should be developed around a 3-stage approach:

- Stage I – Definition of the risk assessment strategic plan
- Stage II – Consolidation of risk assessment criteria and selection of a preliminary list of taxpayers to undergo risk assessment
- Stage III – Individual analysis of taxpayers

In developing the risk assessment strategic plan, a number of alternatives should be evaluated as outlined below.

4.1.1 *Centralized or decentralized approach to risk assessment*

The first alternative to consider in designing the programme is between a centralized or decentralized approach to risk assessment.

In a centralized approach the risk assessment is conducted centrally by a specialist risk assessment team incorporating input from the compliance function, or locally by the tax inspector themselves. This allows the application of more consistent standards, it allows the risk assessment group to develop experience and judgment, and it assures that specialist auditors, trained in risk assessment, will be considering the risk to the administration in various transfer pricing contexts.

In a decentralized approach the risk assessment is conducted by transfer pricing audit teams. This may facilitate the interaction with the taxpayer and, especially when a jurisdiction has a large population of taxpayers to risk assess, could allow a more comprehensive coverage.

A middle course of action could be the engagement of local auditors to gather information for the risk assessment and provide an initial evaluation of that information. This initial evaluation could then go to a central board to revise the initial assessment and sign-off on any decision to go forward with either a more in-depth risk analysis or a targeted audit of certain issues.

General advantages and disadvantages of a centralized or decentralized model for establishing transfer pricing capability are further analyzed in Section 11.5.2 of the UN TP Manual.⁷

4.1.2 *Global vs. industry specific risk assessment*

A choice to be made in designing a programme of transfer pricing compliance is whether the risk assessment should cover the global population of taxpayers or should focus on a specific sector, either because of the sector's importance for the national economy or because of particular base erosion and profit shifting risks.

4.1.3 *Taxpayer's classification based on turnover*

In addition, tax administrations may classify taxpayers based on their turnover in large taxpayers, medium taxpayers, and small taxpayers and decide whether one of those categories is worth dedicating more monitoring activity. Typically, large taxpayers are more likely to be involved in a higher volume of cross-border activities and due to the potential for higher corporate income taxes could be candidates for stricter risk assessment.

4.1.4 *Transactional vs. jurisdiction vs. risk-based approach*

As explained in Section 13.2.3 of the UN TP Manual, three different approaches could be taken into consideration in developing a transfer pricing risk assessment programme.

These include:

- The transactional approach: in this case, the focus of the risk assessment is on specific types of transactions (e.g., transactions with higher risks such as business restructurings, mergers, acquisitions, and exits).
- The jurisdictional approach: in this case, priority is given to the risk assessment of transactions with related entities located in specified tax jurisdictions (e.g., jurisdictions with very low tax rates or with aggressive corporate income tax or transfer pricing rules).
- The risk-based approach: This is, in essence, a hybrid of the transactional and jurisdictional approaches, and could consider factors other than the jurisdiction of the related party or parties and the type of transactions. Such potential factors include the tax compliance status of the local entity, the MNE to which the entity belongs, companies with excessive and / or continued losses despite there being profits at the consolidated group level, etc.

4.2 Sources of information

An effective transfer pricing risk assessment requires knowing the taxpayer, its global business, and its industry. Therefore, the first main challenge of the risk assessment is finding the right information to evaluate transfer pricing risk. Care may need to be exercised in the use of information obtained by the tax administration but not originally collected for audit purposes, in order to avoid contravening relevant data protection or exchange of information conditions, etc.

A list of potential sources of information that may be investigated during the risk assessment phase can be found below.

4.2.1 *Taxpayer's tax return*

The starting point for any risk assessment process would be a review of the tax returns themselves. Many tax administrations require taxpayers who carry out intercompany transactions to supplement their tax returns with forms or other reports that disclose additional information relevant to transfer pricing arrangements. For example, there may be a specific transfer pricing return or an additional schedule that needs to be filed with the tax return setting out information such as types and value of related party cross-border transactions, names and jurisdictions of counterparties, transfer pricing method applied, etc. The information obtained from tax returns largely consists of quantitative information, and often will be processed in a computerized database system at the earliest stages of a risk assessment process.

4.2.2 *Transfer pricing documentation*

Action 13 of the OECD/G20 BEPS project sets out a standardized 3-tiered approach to transfer pricing documentation. Under such standard, the transfer pricing documentation should include:

- (i) A country-by-country report containing certain information relating to the global allocation among taxing jurisdictions of the MNE's income and taxes paid, together with certain general indicators of the location of economic activity within the MNE;
- (ii) A master file containing general information about the MNE relevant to all MNE members;
- (iii) A local file referring specifically to material transactions of the MNE members resident in the local jurisdiction and setting out the taxpayer's transfer pricing methodology for such material transactions.

Chapter 12 of the UN TP Manual provides more details regarding content of the transfer pricing documentation and the challenges faced by developing countries.

4.2.3 *Taxpayer's file and audit records of previous years*

The taxpayer's file maintained in the tax administration, previous years' audit records and risk assessment reports, as well as any information that may relate to other compliance interactions with the taxpayer, may contain useful information which will help build a complete picture of the business activities. In particular, previous years' audit records should contain helpful information to determine how to focus the audit process if it is decided an audit should be conducted.

Information from advance pricing arrangements / agreements (APAs) requested or agreed may also be useful, but as noted in the UN TP Manual, in some cases, the tax administration may have imposed limitations on the use of such information for other purposes in order to encourage the take-up of APAs.⁸

⁸ UN TP Manual, Section 15.3.4.7.

4.2.4 *Information received through exchange of information*

Information received from other tax administrations, either automatically or as a result of a request, may assist in identifying transfer pricing risks. In particular, exchanges of information under double tax treaties (usually regulated by Article 26 of the treaty) have been found productive in some countries in identifying, and therefore tackling, transfer pricing risks.

4.2.5 *Taxpayer's financial statements including notes to the financial statements*

Financial statements are written records that convey the business activities and the financial performance of a company. The balance sheet provides an overview of assets, liabilities, and shareholders' equity as a snapshot in time.

The income statement primarily focuses on a company's revenues and expenses during a particular period. Once expenses are subtracted from revenues, the statement produces a company's profit figure called net income.

The note to the financial statement provides background explanations on the items contained in the financial statements. Where there are requirements to disclose / report uncertain tax positions, these may also be a good source of information on the taxpayer's activities or structuring, in cases where those activities / structures may be novel or more contentious.

The financial statements can provide useful information on the performance and type of operation conducted by the taxpayers and can be used to compute financial ratios.

4.2.6 *Questionnaires issued to selected taxpayers*

Some tax administrations send a questionnaire to selected taxpayers after an initial review of the tax returns. In general, this tool seems to be most often utilized in countries where there is no statutory contemporaneous transfer pricing documentation requirement. These questionnaires ask for additional information regarding transactions with related parties, to help complete the risk assessment process.

4.2.7 *Publicly available information regarding the taxpayer*

A list of potential sources of publicly available information regarding the taxpayer includes:

Internet search

Using the Internet can provide information about particular companies or industries. It is also possible to use the Internet to access some government agencies' databases.

Taxpayer's website

MNE groups usually have a very comprehensive website, providing a wealth of useful information. Such websites will certainly promote what the group does – the services it

provides or goods it sells. Major products or brands will likely be extensively described. The section on investor relations will contain the latest financial statements as well as the latest half-yearly or quarterly figures. Such information can be used to confirm the accuracy of the functional analysis in the transfer pricing documentation and to check some of the facts described by the MNE to tax authorities.

Press reports, the financial and business press and trade magazines

Press reports on individual companies could provide information about the launch of new products, factories opening or closing, strategic partnerships or alliances the MNE is entering into, and sometimes even concrete information such as royalty rates on license agreements they have concluded.

Trade magazines and other information in the public domain can provide useful information on particular companies and the sectors in which the company operates. Information on business sectors can help decide whether declining results for a company reflect a wider malaise for that particular business sector or reveal that the sector was in fact rather buoyant during the period in question. Articles on business sectors may also indicate when a competitor has launched a rival product, which might explain a decline in sales for the company being reviewed.

Commercial databases

Commercial databases take information from a variety of publicly available sources and provide a way of searching for companies that are carrying out broadly similar activities to the company under review. In some countries and in some situations, it can be useful to try and find similar but independent companies carrying out broadly similar activities and compare their financial results to those of the company under review. For the purpose of a transfer pricing risk assessment, the search may be fairly general, being used primarily to survey broadly how the company is performing in comparison with similar companies.

A database search might show that the company under review is completely outside of the range of potential comparables, which will be an indicator that the case is worth looking into in more detail. Alternatively, the company may be near the top or even outperforming the comparables, which probably, though not necessarily, means that time will be better spent focusing on other potential targets for a transfer pricing audit.

In some countries, the absence of a large base of independent companies filing financial data with government agencies will make commercial databases less useful. Further guidance on undertaking transfer pricing analyses in situations where comparables data is lacking can be found in the Platform for Collaboration on Tax's Toolkit *Addressing difficulties in accessing comparables data for transfer pricing analyses*.⁹ Regional comparables may be considered but careful attention should be given to differences between companies in the database and those in the local market. Further guidance on the use of 'secret' comparables (i.e., comparables data or information that is available to the tax administration but cannot be

⁹ Platform for Collaboration on Tax, *op cit*

disclosed to the taxpayer) is available in the UN TP Manual.¹⁰ Experience in transfer pricing risk assessment can greatly enhance the ability of the tax administration to draw meaningful conclusions from data relating to regional comparables.

Customs data

It is possible to use data collected for the purposes of assessing customs duties to obtain details of cross-border transactions, including those between associated enterprises. It is often the case that customs data will be collected and available in real-time. However, it should be noted that customs pricing and arm's length pricing are usually not the same. The existence of a cross-border movement of goods is not always indicative of a transaction, as goods often move within a group without a change of ownership, and other transactions, such as royalty flows, do not show up in customs data. Moreover, without knowledge of the ownership of the intangibles associated with many goods, it can be difficult to assess instances of under or overvaluation. Thus, customs data will be useful in connection with other information, but will not usually be a satisfactory exclusive source of data for risk assessment purposes.

Patent office, registries and other government agencies

Some countries try to build a closer working relationship with the country's patent office in order to help identify cases where cross-border transfers of intellectual property have taken place and to obtain a better understanding of what intellectual property a business is developing. However, patents can be very difficult to understand, and it needs to be recognized that many transfers of intellectual property within a group take place without any notification of transfer to official registries. Similarly, there may be registrations of titles and / or transfers of certain classes of assets such as land which can also provide additional information relevant to the transfer pricing analysis. As with patents and customs data, information that has been collected for purposes other than income tax needs to be considered with care.

Conclusion

In every transfer pricing risk assessment, it is key to use a combination of data sources to gain as much information as possible in order to get the full picture of the taxpayer's background and operations. An analysis of different data sources allows for cross-checking and eases the identification of risks while at the same time clarifying potential issues that are not worth pursuing.

In evaluating the taxpayer's documentation, tax authorities should consider not only whether the documentation requirements are met, but also whether the documentation accurately addresses the controlled transactions and whether the conclusions reached can be considered reasonable.

¹⁰ See Sections 3.6.7 (on secret comparables generally) and 14.3.11 (on the use of secret comparables in audits)

4.3 Detailed risk assessment

4.3.1 Preliminary phase

The risk assessment strategic plan should determine priorities and criteria to select a 'long list' of taxpayers for more detailed risk assessment.

The preliminary phase of the risk assessment should then focus on documentation and information gathering at first, with the aim of gaining a preliminary understanding of the taxpayer's background and of the sector in which it operates.

For this purpose, the following steps are required to be performed:

Collection and review of the prior audit period documentation including:

- Tax returns and associated schedules, including, in particular, any transfer pricing specific returns / schedules or transfer pricing adjustment returns
- Financial statements including notes to the financial statements
- Transfer Pricing documentation (if filed), and in particular:
 - CbC report (where available)
 - Master file
 - Local file
- Information received through automatic or spontaneous exchange of information
- Risk appetite of the MNE (compliance history, governance processes in place, etc.)
- Transfer pricing disputes in earlier years and resolution thereof
- Other publicly available information

Box 4: The OECD Handbook on Effective Tax Risk Assessment (2017)

CbC reporting was designed in the context of Action 13 and is one of four minimum standards within the Base Erosion and Profit Shifting (BEPS) Action Plan.

Under BEPS Action 13, all in-scope large multinational enterprises (MNEs) are required to prepare a country-by-country report with aggregate data on the global allocation of income, profit, taxes paid, and economic activity among tax jurisdictions in which it operates.

As clarified by the UN TP Manual,¹¹ the CbC report is intended to provide a general overview of the allocation of the MNE's global income and taxes paid among countries.

This should help tax authorities to better understand how local entities fit within the activities of large and complex MNE groups, and to conduct more effective risk assessments in order to identify taxpayers and arrangements that may pose a higher tax risk.

¹¹ UN TP Manual, Section 12.2.1.5.

It is noteworthy that it is recommended that only MNEs with annual consolidated revenue of at least EUR 750 million (or an equivalent amount stated in local currency using January 2015 exchange rates) are required to file the CbC report.¹²

In 2017, the OECD published the Handbook on Effective Tax Risk Assessment,¹³ which contains useful guidance on ways to use the information obtained under CbC reporting into the tax risk assessment processes, the types of tax risk indicators that may be identified using CbC reports, and the challenges that may arise in the process.

The Handbook on Effective Risk Assessment is part of guidance prepared by the OECD and available to jurisdictions to assist in the implementation and operation of CbC reporting. Other publications include guidance on the interpretation of elements of the Action 13 minimum standard,¹⁴ on the appropriate use of CbC reports,¹⁵ on the use of the OECD CbC XML schema,¹⁶ and on the effective implementation of CbC reporting.¹⁷

Understanding the taxpayer's industry

- Analyze the taxpayer's industry to identify value (profit) drivers and detect extraordinary events disrupting / affecting global / country-specific economies, industries, and businesses during the tax year¹⁸
- Industry and competitor information
- Value (profit) drivers

Research into taxpayer's background and operations

- Overview of a taxpayer's history, background, and business
- Merger, acquisition, and other reorganization activity
- Geographical, legal, and tax organizational structure information
- Descriptions of patents, trademarks, and other intangibles
- Segmented operational and profitability levels
- Functional activities and their locations
- Significant transactions

¹² OECD (2015). Transfer Pricing Documentation and Country-by-Country Reporting: Action 13 Final Report.

¹³ OECD (2017). CbCR Handbook on Effective Tax Risk Assessment. Available from [Country by Country Reporting - Handbook on effective tax risk assessment \(oecd.org\)](https://www.oecd.org/tax/cbcr/cbcr-handbook-on-effective-tax-risk-assessment/)

¹⁴ OECD (2017a). Guidance on the Implementation of Country-by-Country Reporting. This guidance is updated from time to time and the latest version is available from www.oecd.org/tax/beps/guidance-on-country-by-country-reporting-beps-action-13.htm

¹⁵ OECD (2017b). Country-by-Country Reporting: Guidance on the Appropriate Use of Information Contained in Country-by-Country Reports. Available from www.oecd.org/tax/beps/beps-action-13-on-country-by-country-reporting-appropriate-use-of-information-in-CbC-reports.pdf

¹⁶ OECD (2017c). Country-by-Country Reporting XML Schema: User Guide for Tax Administrations and Taxpayers. Available from www.oecd.org/tax/country-by-country-reporting-xml-schema-user-guide-for-tax-administrations.htm.

¹⁷ OECD (2017d). Country-by-Country Reporting: Handbook on Effective Implementation. Available from www.oecd.org/tax/beps/country-by-country-reporting-handbook-on-effective-implementation.pdf

¹⁸ See also UN (2024). Interstitial Guidance on Transfer Pricing during the COVID-19 Economic Downturn. Available from [Transfer Pricing During COVID-19 Economic Downturn .pdf \(un.org\)](https://www.un.org/transfer-pricing-during-covid-19-economic-downturn.pdf)

Prepare ratio analysis to compute key financial ratios for multiple years, make industry comparisons, and consider the risk of cross-border income shifting

Once sufficient information has been collected and preliminary analyzed, a quantitative analysis using profitability indicators and industry comparison can help to perform an initial screening of the MNE group.

The aim of a quantitative analysis is to ensure that “big fish do not escape through the net” of the risk assessment and to prioritize cases that are worth a more in-depth qualitative analysis.

For this purpose, it may be helpful to compute key financial ratios for multiple years of the taxpayer’s performance and make comparisons. In fact, it is recommended that ratios should be based on both tax and financial data and should be calculated for a sufficiently long time of observation (3-5 years).

The table below summarizes the ratios that could be useful in the preliminary stage of the risk assessment. The relevance of any particular ratio will depend on the nature of the activities performed by the taxpayer (e.g., research and development / manufacturing / service provision). Note that in some cases it may be useful to consider the trend in these ratios over a number of years.

Table 1: Potential risk indicators and their computation

Indicator	Computation
Profit margin	EBIT/Total revenues or Operating profit/Net sales Gross profit/Net sales
Effective tax rate	Income tax accrued/EBIT (Consider worldwide and individual entity effective tax rate)
Profit per unit of economic activity	EBIT/Number of employees or EBIT/Payroll expenses EBIT/Tangible assets
Pre-tax return on equity	EBIT/(Stated capital + accumulated earnings)
Post-tax return on equity	(EBIT less income tax accrued)/(Stated capital plus accumulated earnings)
Pre-tax or post-tax return on assets	EBIT/Total assets (EBIT less income tax accrued)/Total assets
Functional intensity	Operating expenses/Net sales
Reliance on intragroup transactions	Related party revenues/Total revenues Related party expenses/Total expenses

To identify patterns that may suggest higher or lower level of tax risk, the indicators of the tested party should be evaluated against the indicators of potential comparables. The performance of the tested party can be compared with:

1. The standard results of companies in the same industry;
2. The results of the group as a whole;

3. The results of related entities operating in other jurisdictions;
4. The results of the company in earlier periods.

Indeed, one indicator that may flag potential transfer pricing risk will be if the financial results of the company under review substantially deviate from those in the industry.

Further, the comparison of the results of the tested party with those of the group's performance, as well as with those of related party operating in other jurisdictions, will allow the tax auditor to see the "big picture".

In addition, the company's financial performance over time can also be an important risk indicator. A sudden decrease in profitability may be a transfer pricing risk worthy of further investigation. In the same vein, low profits or continuous losses may not reflect the true value of the business and can, therefore, indicate a transfer pricing risk to investigate.

It must be stressed that this initial comparison does not provide a definitive indication as to whether the price for a controlled transaction achieves an arm's length result.

However, analysis of these initial ratios may be useful as a diagnostic tool to identify issues for further examination that have the most significant risk for non-compliance.

It is worth noting that the arm's length principle requires a transactional approach (i.e., a transaction-by-transaction analysis) while, at this stage, ratio analysis and comparison are likely to be performed at the entity level.

Develop a preliminary working hypothesis to identify taxpayers that may pose tax risks

At this stage of the risk assessment, sufficient documentation should have been collected and a quantitative analysis should have been performed to allow a high-level overview of the taxpayer's risk profile.

This preliminary analysis should serve to steer the subsequent compliance activity by focusing resources on taxpayers who need further attention. In this regard, it is important to bear in mind not only the risks that have been brought to light by the available information, but also the potential risks that may need to be hypothesized based on an absence of information, or put another way, not only on what is there but also what may not be there. For example, if there is information to suggest a taxpayer plays an important and valuable role locally (e.g., through its advertising or website) but the local footprint disclosed elsewhere (e.g., in the TP documentation) is minimal, this may prompt questions about the true extent and nature of the local activities.

The table below lists a number of transfer pricing risk flags that should be evaluated at the end of the preliminary quantitative analysis. As noted in the section above, the quantitative analysis should take into account results over a number of years. One-off deviations or risk flags that appear in a single year may not pose the same level of risk as sustained deviations or trends over a longer period. Moreover, in evaluating each of these risk flags, the question of whether the identified risk can likely be adequately explained by known commercial or

non-tax factors must be examined. This table is indicative and should not be regarded as an exhaustive list of possible TP risk flags.

Table 2: Transfer pricing risk flags¹⁹

Transfer pricing risk flags	Brief description	Where to look
The footprint of a group in a jurisdiction	A group with a small footprint may have less potential to pose significant tax risk. However, a small footprint could be misleading if the activities in a jurisdiction are more significant. Particular attention should be paid to structures such as agents and commissionaire that show the intermediation fee (and not the revenue of the goods sold) in local financial accounts.	<ul style="list-style-type: none"> - CbC report - Taxpayer's tax return - TP documentation - Financial accounts
The results of a MNE group in a jurisdiction deviates from potential comparables	Differences between the local performance of the MNE and those of chosen comparables could be a consequence of TP manipulation and should be further investigated to understand the causes.	<ul style="list-style-type: none"> - CbC report - Taxpayer's tax return - TP documentation - Financial accounts
The results of a MNE group in a jurisdiction deviate from industry standards	When the results of a MNE group in a jurisdiction deviate from industry standards this could be a consequence of TP manipulation and should be further investigated to understand the causes.	<ul style="list-style-type: none"> - CbC report - Taxpayer's tax return - TP documentation - Financial accounts - Industry information
There are jurisdictions with significant profits but little substantial activity	Profits may have been shifted away from the jurisdiction where the underlying economic activity is occurring, and therefore, it should be investigated whether the local entities of the MNE have transactions in place with	<ul style="list-style-type: none"> - CbC report - TP documentation - Exchange of information

¹⁹ The table summarizes the relevant transfer pricing risk flags which are laid out in Section 13.2.5 of the UN TP Manual; in Annex 2 of the OECD CbCR Handbook on Effective Tax Risk Assessment 2017; in par. 131 of the OECD Public Consultation Draft Handbook on Transfer Pricing Risk Assessment 2013.

	related entities located in such low substance / high profit jurisdictions.	
There are jurisdictions with significant profits but low levels of tax accrued	A low effective tax rate can indicate that a MNE group is engaging in base erosion and profit shifting to shelter taxable income. In this case, attention must be paid to the analysis of transactions of the local entities with related entities located in jurisdictions that pose BEPS risks.	<ul style="list-style-type: none"> - CbC report - TP documentation - Exchange of information
There are jurisdictions with significant activities but low levels of profit (or losses)	Profits that are attributable to a jurisdiction may be shifted through transfer pricing manipulation.	<ul style="list-style-type: none"> - CbC report - TP documentation - Exchange of information
A group has activities in jurisdictions which pose a BEPS risk ²⁰	Transactions with jurisdictions that pose a BEPS risk should be carefully investigated.	<ul style="list-style-type: none"> - CbC report - Exchange of information
Transfers of intangibles to related parties	Transactions of this nature raise difficult valuation questions, especially where the intangibles are unique, and consequently, there is a lack of comparables.	<ul style="list-style-type: none"> - Taxpayer's tax return and / or schedules - TP documentation - Taxpayer's website - Financial accounts, including uncertain tax position disclosures - Press reports / trade magazines - Patent office
Business restructurings	The risks associated with a restructuring are different for the various jurisdictions affected. The country where the MNE is headquartered would face issues, such as the valuation of externalized intangibles, deemed disposals of assets for capital gains tax purposes, etc. In addition, the headquarters' jurisdiction	<ul style="list-style-type: none"> - Taxpayer's tax return and/or schedules - TP documentation - Taxpayer's website - Financial accounts, including uncertain tax position disclosures - Press reports - Patent office

²⁰ Countries are likely to have their own views on which jurisdictions are considered to pose a BEPS risk. In many cases, it may include jurisdictions which impose no or only nominal rates of corporate income taxes. It may also include jurisdictions with specific features which have been used by local taxpayers to avoid taxes through BEPS structures or transactions.

	may have to deal with the classification and benchmarking of profits for the “principal / entrepreneur” remaining or created due to the restructuring. On the other hand, the jurisdictions of the subsidiary would mainly be concerned about risk stripping and loss of (future) profits.	
Specific types of payments	Certain type of payments such as interest, insurance premiums, and royalties pose generally pose higher risks than other transactions. This is because the underlying rights are highly mobile, and consequently, there is a risk that the payments do not reflect the true value being added by the related party.	<ul style="list-style-type: none"> - Taxpayer’s tax return and/or schedules - TP documentation - Financial accounts
Significant transactions with related parties in low tax jurisdictions	Where transactions take place with lowly taxed related entities there is a risk that mispricing will incorrectly attribute excess profits to the lowly taxed jurisdiction.	<ul style="list-style-type: none"> - TP documentation - Taxpayer’s tax return and/or schedules - Financial accounts and notes - Exchange of information - Customs data
Excessive debt	Debt that appears to be in excess of the amount that an entity could borrow on a stand-alone basis, or interest rates that appear to be below or in excess of market rates.	<ul style="list-style-type: none"> - Taxpayer’s tax return - TP documentation - Financial accounts
Local low profit or loss-making local companies (especially when the MNE group as a whole is profitable)	Repeated losses or local low profit (especially when the MNE group as a whole is profitable) may be evidence that the reported results do not reflect the true value of the business.	<ul style="list-style-type: none"> - CbC report - Taxpayer’s tax return - TP documentation - Financial accounts
The existence of centralized supply chain companies in favorable tax jurisdictions, i.e., centralized sourcing or	The existence of centralized supply chain companies in a low tax jurisdiction may be exploited to shift profit	<ul style="list-style-type: none"> - TP documentation - Financial accounts

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	through transfer pricing manipulation.	
Material commercial relationships with companies in jurisdictions that employ safe harbours or similar rules that do not align with the arm's length principle	Substantial deviation from the arm's length principle in the TP rules in a jurisdiction may have an impact on the prices of the transactions with the related entity located in such jurisdiction.	- TP documentation - Financial accounts - Customs data
A poor tax compliance history	A history of poor past behaviour of the taxpayer towards tax compliance should be carefully evaluated.	- Taxpayer's file and audit records of previous years
Lack of documentation to support transfer prices	Poor TP documentation, or lack of, may cast doubt on the reliability of the transfer prices themselves.	- Taxpayer's tax return and / or schedules - TP documentation

At the end of the preliminary quantitative analysis, tax authorities should be in a position to perform a preliminary cost / benefit analysis to evaluate not only the tax risks posed by a specific taxpayer but also what the likely amount of tax at stake is, how much tax administration resource will be required to establish the amount expected, and whether time would be better spent on another case.

Where it appears already at an early stage that the level of potential tax risk posed by a taxpayer is low, a decision may be made at that time that no further assessment or compliance action is required. The quicker risks and concerns can be ruled out, the more resources can be focused on risks and taxpayers that need further attention.

In this preliminary quantitative analysis, the CbC report can play a crucial role in providing tax authorities with useful information to better understand how the MNE local activities fit within the larger activities of the MNE group. Taxpayers can be benchmarked against other entities in the same MNE group, as well as against those in other groups, to identify discrepancies that may be indicators of increased risk in a particular jurisdiction.

However, CbC information should not be used as a substitute for a detailed transfer pricing analysis of individual transactions and prices based on a functional analysis and a comparability analysis.

4.3.2 Execution phase

As explained above, the purpose of the initial quantitative analysis is to provide a rough indication of the general reasonableness of the outcomes of the taxpayer's overall transfer pricing.

Once a 'long list' of potential risk taxpayers has been identified, the execution phase should focus on narrowing the long list to a short list by conducting a more detailed analysis, including information that may be specifically requested from the taxpayer.

For this purpose, the examination should move from a quantitative entity level risk analysis towards a more qualitative transaction level risk analysis. The risks identified in the preliminary phase should be connected to the transactions performed by the taxpayers to understand whether the transfer pricing could be the origin of such risks.

Focusing on transactions it should be recalled that transfer pricing risks can arise in three broad scenarios:

1. Recurring transactions with related parties which have the potential to erode a jurisdiction's tax base over time. This risk can involve any tax-deductible related party payment, including sales or purchases of products or services, but there is a particular risk where intragroup payments are of a type which can be hard(er) to value. These might include payments of interest, insurance premiums, service fees, management fees, and royalties.
2. A large or complex one-off transaction, including business restructurings and transfers of key income-producing assets. These transactions can have a significant effect on the tax position of entities in the year the transaction occurs, but also on an ongoing basis as new related party transactions are put in place which need to be priced.
3. A lack of effective tax control frameworks in place to control, document, and review the pricing of related party transactions on an ongoing basis.

During this phase, the following steps may be considered:

Conduct a preliminary functional analysis

The functional analysis aims to determine which functions are performed, which assets are used, and which risks are assumed by each party and is at the heart of every transfer pricing analysis.

In order to understand if a controlled transaction poses transfer pricing risks, it is inevitable to perform some sort of high-level functional analysis to better understand the transactions and compare them with third parties' activities with similar characteristics.

However, as clarified in Section 13.2.1.1 of the UN TP Manual, a risk assessment does not involve a full functional analysis. It is instead intended to identify whether such a full analysis is warranted given the constraints on a tax administration's resources.

The preliminary functional analysis can follow a two-step approach:

- First, review the functional profiles of the companies involved in the covered transactions taking into consideration the actual delineation of the transactions. For example, if the MNE claims it performs distribution activities through low-risk distributors, tax administrations should evaluate whether the functions, assets, and risks of the distribution entities are in line with the functional profile of a low-risk distributor.
- Second, evaluate whether the transfer pricing methodology and the manner in which it is applied by the taxpayer is coherent with the identified functional profile. The coherence of the methodology may be evaluated against the transfer pricing method(s) selected (including the profit level indicator, where applicable) and the comparables (taking into account any comparability adjustments) used by the taxpayer to price the transactions under review.

At this stage, the functional analysis should be conducted predominantly based on the information of the documents at the disposal of the tax administrations.

However, transfer pricing documentation are not always immediately available to tax administrations. In this case, tax administrations may decide to send an ad hoc questionnaire to the taxpayer and ask for additional information regarding transactions with related parties. The questionnaire can include requests for financial data, other statistics (e.g., headcount by division), functional information, organizational setup, and explanations of financial / economic performance. Questions can also be aimed at seeking further explanation on the transfer pricing analysis, such as the choice of method or assumptions built into an economic analysis.

The table below summarizes a number of recurrent issues that are normally met in transfer pricing analysis and can be used as (part of) a checklist tool in performing the risk assessment. Note that the table only covers a selection of the main types of risks that may be found.

Table 3: Checklist for risk assessment²¹

Type	Inbound transactions	Outbound transactions
Funding	Thin capitalization	Interest free loans
Interest rates	Excessively high interest rates	Excessively low interest rates
Goods	<ol style="list-style-type: none"> 1. Offshore procurement / sourcing companies 2. General mispricing 	<ol style="list-style-type: none"> 1. Offshore marketing companies to keep profits offshore 2. General mispricing

²¹ Table 13.T.1 of the UN TP Manual.

Services ²²	<ol style="list-style-type: none"> 1. Excessively high fees relative to benefits provided 2. Charging when no services were received 3. Duplication of services and / or provision of shareholder services 4. Purported value-based service charges (charged by reference to a % of sales / revenues) 	<ol style="list-style-type: none"> 1. No charges at all 2. Excessively low fees relative to benefit provided
Intangibles/ Intellectual property	<ol style="list-style-type: none"> 1. Excessively high charges 2. Duplicating charges through royalties above inflated prices 	<ol style="list-style-type: none"> 1. No charges for intangibles developed locally 2. Externalizing intellectually property without reward
Structures	<ol style="list-style-type: none"> 1. Restructuring 2. New structures 	<ol style="list-style-type: none"> 1. Restructuring 2. New structure 3. To avoid / minimize imputation through controlled foreign corporations 4. Use of offshore branches in low-tax jurisdictions with double taxation treaties

4.3.3 Outcome phase

Estimating the degree of risk is not a formulaic process and judgment and understanding of the facts insofar as possible is required.

In quantifying the level of risks posed by a single transaction, tax authorities may evaluate:

1. The amount of tax at stake
2. The number and / or the importance of risk factors identified
3. The existence of systematic or recurring risks which need to be addressed

For cases where the identified risk is low, no further compliance action needs to be undertaken. For higher risk cases, it may be appropriate to flag the case for a “watching brief” and follow up compliance action in the future (generally for medium risk cases), or to commence an audit (higher or systemic risk cases).

Tax authorities may consider using a “traffic lights” classification of the level of risks identified in each analyzed transaction as in the table below.

²² A threshold test for service transactions is whether a chargeable service exists. See UN TP Manual, Section 5.1.2.

Table 4: Traffic light risk classification and follow-up

Risk classification	Follow-up compliance activities
High risk	Tax audit
Medium risk	Monitoring activities, ongoing communication with the taxpayer
Low risk	No further actions

Audit activities can take different forms ranging from desk audits to on-site audits. The final decision on whether to initiate an audit and the type of audit to carry out will generally need to be considered in relative terms, i.e., prioritizing identified risks in the population against available compliance resources.

As specified in Section 13.2.8 of the UN TP Manual, 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 they lead to a detailed audit or to tax assessment.

Best practice: Tax administrations should design templates containing relevant information of the risk assessment conducted.

Ideally these should include:

- Statutory filing requirements
- The period analyzed
- A table with the indicators computed
- A short description of the transactions analyzed and of the information reviewed
- A measurement of the risk attributed to the transactions (e.g., based on a tax contingency estimate, perhaps combined with an estimate of the likelihood of the risk materializing)
- The final outcome of the risk assessment process, i.e., what was recommended and why.

Box 5: Programmes of multilateral risk assessment – OECD ICAP and EU ETACA

The new frontier of risk assessments takes the form of multilateral risk assessment i.e., a risk assessment involving the collaboration of several tax administrations. Developing multilateral risk assessment programmes is key to ensuring that transfer pricing risks are tackled effectively. At the same time, it is also important for taxpayers to have a certain level of tax certainty and that profits are not subjected to double taxation.

It should be recognized that in the transfer pricing field, tax administrations do not always share a common interest. This is because, to prevent double taxation, a well-founded primary (upward) adjustment by one tax administration may need to be followed by a corresponding (downward) adjustment by the other. This implies that the second tax administration would have to reduce its tax base accordingly, which is most probably an

option that a tax administration would preferably avoid taking, especially if they have not been directly involved in the audit.

In 2018, the OECD launched the International Compliance Assurance Programme (ICAP), a voluntary programme for a multilateral cooperative risk assessment and assurance process.

The programme is designed to be an efficient, effective, and coordinated approach to provide MNE groups willing to engage actively, openly, and in a fully transparent manner with increased tax certainty with respect to certain of their activities and transactions.

Multilateral risk assessment provides benefits for both tax administrations and taxpayers including:

- Fully informed and targeted use of CbC reports and other information held for risk assessment
- An efficient use of resources
- A faster, clearer route to multilateral tax certainty
- Cooperative relationships between MNE groups and tax administrations
- Fewer disputes entering into MAP

The *International Compliance Assurance Programme – Handbook for tax administrations and MNE groups*²³ provides an overview of the programme and guidance on how to participate.

In 2021, the European Commission launched its own programme of multilateral risk assessment called European Trust and Cooperation Approach (ETACA). The purpose of the programme is to bring together EU tax administrations to perform a multilateral risk assessment of the transfer pricing policy of MNEs operating within the European internal market.

The primary objective of the programme is to improve the tax certainty of cross-border transactions within the EU internal market, avoiding as far as possible different interpretations leading to double taxation situations, and thus, reducing transfer pricing disputes.

In addition, the programme facilitates a “learning by doing together” approach with the aim to develop a common approach to transfer pricing risk assessment by European tax administrations.

The guidelines²⁴ of the programme provide an overview of the different phases of the programme and of the approach suggested to perform a high-level transfer pricing risk assessment.

²³ OECD (2021). *International Compliance Assurance Programme – Handbook for tax administrations and MNE groups*. OECD Publishing, Paris.

²⁴ European Commission (2021). *Guidelines - European Trust and Cooperation Approach (ETACA)*.

5. Road map for a transfer pricing audit

The aim of this Section is to provide a guide to good practices and processes to assist with the planning, execution, and resolution of transfer pricing audits. The goal of a transfer pricing examination is to determine an arm's length result, taking into account the facts and circumstances of the case.

Transfer pricing examinations are factually intensive and require a thorough analysis of the economically relevant characteristics of the transaction(s), including the functions performed, assets employed, and risks assumed along with an accurate understanding of relevant financial information. They are resource intensive for both the tax authorities and taxpayers.

The tax administration should start a transfer pricing audit only where the risk assessment concludes that a full transfer pricing audit of one or more issues is appropriate.

The process of an audit can be articulated in different phases, similar to the risk assessment.

5.1 Preliminary phase

When tax authorities decide to start a transfer pricing audit, a number of preliminary steps should be followed. In particular:

5.1.1 *Setting up a TP audit team*

As explained in Section 14.1.2 of the UN TP Manual, ideally a TP audit team should comprise auditors with different backgrounds. It is important to have a good mix of economists, accountants, and lawyers as well as the presence of an IT audit specialist, and where possible, an industry specialist. A key issue for a tax administration is to ensure transfer pricing audit approaches are uniform over the whole country. This can be ensured by appointing managers who typically have responsibility for audits in several regions and across a range of cases.

5.1.2 *Reviewing prior audit period work-papers and risk assessment outcomes*

The TP audit team should start by analyzing the findings of the risk assessment and the prior audit period work papers in order to understand which transactions should be audited and how they should be approached.

5.1.3 *Establishing a team, examination plan, timelines, and key milestones*

The audit team should establish an estimated audit timeline with key milestone dates for completion of the transfer pricing examination.

5.2 Execution phase

The execution phase of transfer pricing audits includes determining the facts, applying the law and technical guidance to those facts, and understanding the various tax implications.

The audit team should request any additional information not obtained during the risk assessment phase.

Typically, the audit team should engage with the taxpayer, including through conducting interviews with managers / key staff as part of the functional analysis. Where possible, this may include site visits.

5.2.1 *Gathering information*

One of the major activities 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.²⁵ This should include important contextual information about the taxpayer's industry, including the nature and levels of competition, regulatory factors, and other elements that may affect the taxpayer and its environment.²⁶ Some of this contextual information may be available publicly.

Other information more specific to the taxpayer and the intragroup transactions are less likely to be publicly available. For these, the principal means for the audit team to collect the necessary information is through written information request(s). Certain information needed for the transfer pricing audit may already be in the hands of the tax authorities. The audit team should request any information not obtained during the risk assessment.

It is important to request the documents and the information needed at the very beginning of the 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.

The table below summarizes the information that the audit team may consider requesting as appropriate at the beginning of the audit. All information should reflect the facts at the time of the period under audit.

Table 5: Scope of information requests at the beginning of an audit²⁷

Information request
1. Corporate profile information (including the corporate group's history)
2. Organizational chart (setting out the number of employees, as well as their broad categories of work and activities)

²⁵ See UN TP Manual, Section 14.3.3.

²⁶ See UN TP Manual, Section 3.3.1.

²⁷ The table is based on the list of information summarized in Section 14.3.8 of the UN TP Manual.

3. Transactional structure: a business flow chart or value chain analysis (from invoicing and settlement to the actual delivery flow)
4. List of distribution channels and retail outlets if applicable: location, size, opening hours, 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 structure of group companies
7. Basic business agreements, distribution agreements, and other agreements with related parties (including written as well as implicit arrangements)
8. Corporate profile of the related parties
9. Documents related to the determination of an arm's length price
10. Transfer pricing method and list of margins by categories of product / services for the audit period
11. Latest financial data regarding the sales, cost of goods sold, operating expenses, operating profits, and profit before tax for the audit period
12. Group global consolidated profit, loss statement, and ratio of taxpayer's sales to group global sales for the audit period
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 the audit period
14. List of gross and operating profits by category, by product, and by distribution channel with details of losses on disposal of assets and losses from obsolescence for the audit period
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 the audit period

As noted in the UN TP Manual in Section 14.3.6.2, much of this information can be found in the taxpayer's transfer pricing documentation, assuming it has been prepared in compliance with the recommended standard as described in Chapter 12 of the UN TP Manual.

5.2.2 Identifying and analyzing the economically relevant characteristics, including conducting a functional analysis to accurately delineate the transaction(s)

The UN TP Manual stresses the importance of accurately delineating the intragroup transaction(s) to be evaluated. After analyzing the contextual and other information described in 4.2.1 above, it will be essential for the audit team to work towards accurately delineating the intragroup transaction(s) that are the focus of the audit. In this respect, the UN TP Manual sets out five categories of economically relevant characteristics or comparability factors that need to be considered. These are:

- The characteristics of the property or service transferred;
- The contractual terms;
- A functional analysis of the controlled transaction under examination;
- The economic circumstances; and

- The business strategies followed by each of the parties.

Detailed guidance on these factors is available in the UN TP Manual.²⁸ In many cases, the most challenging part of this process will be the functional analysis, which will therefore be focus of the remainder of this Section. However, it is essential that the functional analysis is considered together with the other economically relevant characteristics and contextual factors. It is important that a transaction or activity is not considered in isolation from the global value chain and industry context in which it is carried out. This kind of additional information will help to define which functions, assets, and risks are the most economically significant in a particular case.

A functional analysis identifies the economically significant activities performed regarding the transaction. An economically significant activity materially affects the price charged in a transaction or the profits and / or losses from a transaction.

The audit team should deepen the preliminary functional analysis performed in the risk assessment and verify whether the facts and circumstances reported by the taxpayer in the TP documentation are true.

The audit team should consider performing the following actions, as appropriate:

- Identify functions performed by each entity with respect to the controlled transaction under analysis;
- Identify risks assumed by each entity with respect to the controlled transaction under analysis and verify that the conduct of the parties is consistent with the way in which risk is allocated in the intercompany agreement(s);
- Identify assets utilized by each entity;
- Identify title flow, product flow, services performed, and money flow;
- Identify value drivers of the business or transaction.

To perform a proper functional analysis, the audit team should consider performing the following activities, as appropriate.

5.2.3 *Reviewing intercompany agreement(s)*

As part of the review of contractual terms, the audit team should specifically perform a review and analysis of relevant intercompany agreements to understand legal terms and content of intercompany agreements with the aim to:

- Determine relevant parties;
- Identify important terms of the agreement;
- Identify compensation and forms of payments;
- Assess the contractual risks assigned to the controlled parties and determine whether the parties have control and financial capacity in relation to such risks;

²⁸ See UN TP Manual in Section 3.3.2 and Section 3.4.

- Determine if the conduct of the parties is consistent with the written agreements.²⁹

5.2.4 *Requesting to visit site / facilities*

A visit to the site / facilities can help to better understand the economic activity performed by the taxpayer. The audit team could be accompanied on the visit by employee(s) of the taxpayer who can describe the activities at particular locations and respond to questions.

This guide should consider the exercise as being similar to an interview and the findings of the visit should be adequately documented.

5.2.5 *Conducting interviews with managers / key staff*

In order to properly delineate the functional profile of the taxpayer and cross-check the information contained in the TP documentation, the audit team should conduct functional interviews with relevant staff.

The interviews assist the audit team’s functional analysis for purposes of determining the functions performed by the taxpayer and related parties and evaluating potential comparable transactions. The audit team should choose the personnel to interview based on the organizational charts and in collaboration with the taxpayer’s representatives.

If the taxpayer is engaged in distribution activities, the table below provides a sample of ten questions that may be asked in order to help understand the taxpayer’s operations.

Table 6: Sample questions to help understand taxpayer operations (distributor)³⁰

Examples of questions for personnel of a company engaged in distribution activities
1. Could you describe your role and responsibilities within the company’s organization?
2. What is your reporting line?
3. What degree of autonomy do you have in taking strategic decisions and / or in conducting day-to-day operations?
4. Are affiliates manufacturing the same or similar products to those distributed by the taxpayer?
5. Is technology transferred between affiliates and the taxpayer?

²⁹ Section 3.3.2.1 of the UN TP Manual discusses the importance of accurately delineating the transaction(s) to be priced and notes that “[...] the contractual terms will generally be the starting point for the analysis (as clarified or supplemented by the parties’ conduct); and to the extent that the conduct or other facts are inconsistent with the written contract, the parties’ conduct (rather than the terms of the written contract) should be taken as the best evidence of the transaction(s) actually undertaken”.

³⁰ The table builds on Section 14.2.2.3. of the UN TP Manual.

6. Are trademarks and other marketing intangibles being used to market the product?
7. Which members of the MNE developed the trademarks and other marketing intangibles?
8. Which members of the MNE devise and carry out marketing, advertising and promotion activities?
9. Which members of the MNE created the sales tools?
10. Which members of the MNE created and maintains the list of customers?

If the taxpayer is engaged in manufacturing activities, the table below reports a sample of ten questions that may be asked in order to understand the taxpayer's operations.

Table 7: Sample questions to help understand taxpayer operations (manufacturing)³¹

Examples of questions for personnel of a company engaged in manufacturing activities
1. Could you describe your role and responsibilities within the company's organization?
2. What is your reporting line?
3. What degree of autonomy do you have in taking strategic decisions and / or in conducting day-to-day operations?
4. Are affiliates distributing or selling the same or similar products to those the taxpayer manufactures?
5. Is the taxpayer using the same or similar manufacturing intangibles to those its affiliates are using?
6. What patents and/or know-how are involved in the manufacturing process?
7. Is there a cost contribution arrangement in place?
8. What research and development activities are conducted?
9. What members of the MNE direct and perform research and development?
10. How are the results of research and development disseminated among members of the MNE?

If the taxpayer is charged for intragroup services, the table below reports a sample of eight questions that may be asked to understand the taxpayer's operations:

³¹ The table builds on the questions reported in the UN TP Manual in Section 14.2.2.3.

Table 8: Sample questions to help understand taxpayer operations (intragroup services)

Examples of questions for personnel of a company that receives intragroup services
1. What is the percentage of intragroup service payments as a percentage of total operating expenses during the financial year?
2. What are the different components that make up the intragroup services that have been received by the taxpayer?
3. What proportion of the intragroup services fees constitute third-party cost for the MNE group?
4. What are the supporting documents that the taxpayer can furnish to show services have been received and the benefits are commensurate with payment made?
5. Are there any duplicative services or shareholder services for which the taxpayer is receiving a charge?
6. Does the taxpayer make payment for any standby services?
7. If the charge is coming with a markup, can you please provide supporting analysis to establish that the markup is at arm's length?
8. What are the allocation keys that are being used by the Group for charging the taxpayer? Are there any revenue-based allocation keys?
9. Are the service fees determined with reference to a percentage of sales / revenues? If so, please explain the relationship between sales / revenues and the value of the service and why this is the most appropriate way to determine the arm's length price of the service.

Each interview should be adequately documented in a report to be signed by the interviewee and by the audit team.

5.2.6 Determining the functional profile

The functional analysis should aim to define the functional profile of the taxpayer as well as of the related entities with which commercial transactions take place.

This process should also confirm (or disprove) the functional profile as reported by the taxpayer in the TP documentation.

5.2.7 Reviewing the transfer pricing methodology

The audit team should evaluate whether the transfer pricing methodology applied by the taxpayer is coherent with the identified functional profile.

The coherence of the methodology should be evaluated against the transfer pricing methods selected and the comparables used by the taxpayer to price the transactions under review.

5.2.8 *Issue presentation and resolution*

The audit team could benefit from meetings with the taxpayer to discuss results before finalizing the audit report. The meeting with the taxpayer should focus on the following:

- Determine whether and to what extent the taxpayer agrees with the facts as presented;
- Evaluate the taxpayer's position and understand the nature of disagreements;
- Engage in a dialogue with the taxpayer to determine whether a principled resolution can be reached including discussion of the draft transfer pricing audit report to the taxpayer to determine areas of agreement and for any apparent errors/inconsistencies.

5.3 Audit closing

The audit should end with a final report summarizing all audit operations carried out and the outcome of the arm's length analysis performed. In particular, the final report should include:

- Executive summary;
- Summary of the audit operations carried out;
- Factual background and functional analysis of the taxpayer and the transaction(s) at issue;
- Summary of taxpayer's transfer pricing methodology for the transaction(s) at issue;
- Discussion of taxpayer's methodology and analysis for the transaction(s) at issue;
- Tax administration assessment of the remuneration at arm's length of the transaction(s) at issue;
- Summary of the proposed transfer pricing adjustments;
- Any settlements or agreements reached with the taxpayer, including information on the final adjustments applied;
- Conclusion.

Box 6: Joint Audits

Joint audits are another tool that may be used by tax administrations to tackle transfer pricing issues more effectively while improving dispute prevention.

In an environment where businesses operate on a global basis and sell goods and services in multiple jurisdictions, there is a need for tax administrations to cooperate more closely to tackle profit shifting and minimize costly and time-consuming disputes.

A joint audit involves two or more tax administrations that come together and form a single audit team in order to examine an issue/set of transactions that pertain to one or more related taxpayers (with cross-border economic activities). The aim of this exercise is to agree on a single audit report at the end and assess the related taxpayers to tax on this basis. Through this process, the tax authorities are expected to form a more comprehensive understanding of the audited taxpayers' affairs and conclude with an assessment that does not result in double taxation or non-taxation, and obviously there is no need for a dispute resolution mechanism such as the MAP procedure.

In 2019, the OECD Forum on Tax Administration had published a report³² that provides best practices for performing joint audits and identifies possible areas of improvement.

Previously, in 2018, the EU Joint Transfer Pricing Forum had published a report³³ to encourage European tax administrations to cooperate more closely and provide them with a set of best practices for a coordinated approach to transfer pricing controls.

5.4 Follow up phase

The outcomes of the audit should be linked with other tools and procedures. In this regard, it may be useful to evaluate:

- The implication of the audit conclusions on subsequent years. A transfer pricing audit for recurring transactions may be extended to cover more financial years if the taxpayer signals that there's no intention to rectify intercompany transactions in line with the audit conclusions.
- The relations with dispute prevention (unilateral and bilateral APAs) and resolution mechanism (MAP). A taxpayer may seek to enter in an APA, where an APA programme is available, to secure tax certainty for future years. When evaluating the application for the APA, the conclusion of the audit should be carefully considered. In addition, it should be considered whether an APA is only filed to impede an audit to commence or continue. A transfer pricing audit is likely to result in double taxation. This is

³² OECD (2019). Forum on Tax Administration: Joint Audit – Enhancing Tax Co-operation and Improving Tax Certainty

³³ EU Joint Transfer Pricing Forum (2018). A coordinated approach to transfer pricing controls within the EU.

because, to prevent double taxation, a well-founded primary (upward) adjustment by one tax administration should be followed by a corresponding (downward) adjustment by the tax administration of the related entity. The resolution of double taxation is typically dealt with in the context of a MAP between competent authorities. Especially in case of substantial transfer pricing adjustments, a preventive dialogue between the audit team and the competent authority may be beneficial.

- Evaluation of the risk assessment phase with audit results. At the end of the audit, it is important to cross-check if the risks identified in the risk assessment phase materialized and whether they led to an actual transfer pricing adjustment. Equally, it is crucial to understand whether audit activities identified other facts and circumstances that may pose transfer pricing risks that were not previously identified.
- Update of transfer pricing database. To improve the risk assessment procedure, it is essential that the database with information on the taxpayers is constantly fed with the result of audits. This would ensure that the risk profile of a taxpayer is constantly updated to guarantee the effectiveness of the risk assessment.

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