CRA Insights:
Transfer Pricing

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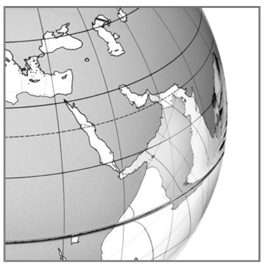
ICC Transfer Pricing Conference in Paris

Potentially a significant milestone in developing a global model for documentation



By Alberto Pluviano

On April 28, 2010, the International Chamber of Commerce (ICC) organized a conference in Paris entitled “Transfer Pricing Documentation and Dispute Resolution: Making or Breaking the Corporate Tax.” Qualified speakers from OECD, the European Union, governments, companies, advisors, and of course ICC itself attended. The meeting was organized around five panels:

- Current State—What is the reality today
- The role of transfer pricing documentation
- Documentation and dispute resolution
- Options for a global model
- Future State—Where do we go from here?

In this article, the author (who participated as a speaker on the panel “Options for a global model”) reports on discussions about transfer pricing documentation with a focus on the practical aspects for multinationals when dealing with documentation issues.

Current status of documentation issues

Various corporate speakers voiced feelings of frustration due to the fact that the target seems to be moving constantly higher and higher despite increasing efforts to develop structured and comprehensive sets of documentation. This is primarily due to the increasing number of countries that are implementing documentation requirements. In addition, the newcomers are often smaller countries, so documentation is more difficult to manage due to the lack of skilled resources.

Speakers also expressed frustration due to the formalistic approach taken by some country regulators; they request very detailed sets of information to be included in the transfer pricing documentation. In some cases, country regulators impose their local language upon documentation even within the European Union where a common “master file” should be accepted in a common language.

Finally, the corporate speakers expressed a widespread feeling that certain tax authorities continue to ask for a disproportionate amount of detailed information during tax audits regardless of the quality of the transfer pricing documentation. In other words, we are far from finding a reasonable balance between costs and resources (meaning both taxpayers' and tax administrations' resources) vs. importance of the risk and materiality of the transactions. In addition, speakers expressed a significant feeling of uncertainty about how the various local authorities will assess these elements and will define a satisfactory level of documentation.

Successful approaches

Companies that consider their documentation experience quite successful tend to have similar approaches. They have developed a centralized management and a centralized model (i.e., the bulk of information is common to all countries' documentation). They also tend to centralize the collection of information and the actual redaction of the documentation reports. As a result (and most importantly), they are able to integrate their documentation into a tax audit "communication strategy." This last point is particularly important and, in the author's experience, has been a vital element in successfully managing transfer pricing audits. Even a documentation package of the highest quality is not self sufficient, and the approach of relying upon the quality of the documentation without carefully managing the communication with auditors will often bring a high number of additional requests from the tax auditors. Proper communication between the companies and the tax auditors will help prevent misunderstandings.

Interestingly, even in countries that have not yet adopted formal transfer pricing documentation requirements, it may be in the best interest of a company to proactively deliver a transfer pricing documentation package to the tax authorities even if not requested.

Current status of global models

The 1995 OECD Guidelines set only general principles in terms of a good approach for documentation from both a taxpayer and tax administration point of view, without prescribing a specific format for a transfer pricing documentation package.

In the 2002 to 2003 timeframe, the Pacific Association of Tax Administrators (PATA) developed an outline for a documentation package that could be prepared and used for transfer pricing documentation compliance and penalty avoidance. The PATA package has often been criticized as a burdensome list because it includes all possible requirements of the participating countries rather than searching for a balanced common denominator.

In 2004, the International Chamber of Commerce (ICC) Committee on Taxation released its statement of principles concerning the standardization of transfer pricing documentation. While this will be discussed in detail in the following section, it is worth noting that, although recognized and utilized as a valid reference by various taxpayers and tax authorities, this has not yet developed into a largely recognized standard.

In 2006, the European Union Council approved a code of conduct for transfer pricing as a result of the recommendations of the European Union Joint Transfer Pricing Forum (EUJTPF). The main objective was to create a standardized and simplified model for European Union (EU) countries. The core element of this model is represented by the "master file" approach, i.e., the possibility for the taxpayer to develop a unique common document for all its EU subsidiaries. A separate country document would contain only the specific local country information.

In practice, each country's documentation will consist of two elements:

- The master file, common to all EU companies of the multinational group, containing all common information
- The country file, including only the set of data and information specific to the country

In principle, the master file should be accepted in a common language thus avoiding burdensome translations and the use of Pan-European comparables should also be accepted.

The master file approach is explicitly "optional" for taxpayers and has an "all-in/all-out" clause. A taxpayer adopting this model must use it for all EU countries in order to get the benefits of a penalty protection. This penalty protection is recommended by the EU and should be granted to taxpayers in EU countries when implementing in good faith the master file approach. It is important to note that this aspect of the master file approach is "optional" and thus does not formally bind the country tax authorities. The master file has become quite rapidly a recognized standard within the EU for two main reasons:

1. Almost all European countries introducing formal documentation requirements after 2006 have adopted a master file and country file model that is similar to the EU model. The main difference is that this model, which was originally "optional," has de-facto become compulsory in several countries. As a result, implementation difficulties have been created in some cases.

2. Several multinationals have "informally" adopted this standard. They recognize a significant practical advantage in a model which allows them to develop a unique Pan-European document that includes all the information that is common to all countries. Also, I refer to this as a significant practical advantage because: 1) if more information is included in the master file, the individual countries' documents will be smaller; and 2) country documents are variable by nature because they describe local specific information, so the smaller the documents are, the easier it is to manage and review them.

The reason for companies to adopt the model "informally" is the "all-in/all-out rule." A typical example of problems leading to this approach is the fact that certain EU countries still want transfer pricing documentation translated into their local language despite the EU's recommendations. For example, if a company has a huge master file and yet very small and limited activity in a country that requires all documentation to be translated into the local language, the company will reasonably opt for a simplified documentation package for that country. In addition, the recommended penalty protection is not really perceived as a guarantee by any country.

The ICC proposal

The ICC 2004 statement of principles developed into a proposed transfer pricing documentation model published in 2008. The essence of the ICC approach was to offer a balanced solution that satisfies multinationals' need to: i) utilize existing financial data routinely prepared by the business and ii) get relief from exposure to penalties while satisfying the tax administrations' requirement for availability of data necessary to conduct an efficient and complete transfer pricing examination.

The ICC proposal is original because it includes a sample documentation package that can be easily utilized in practice. The sample package includes the following main sections:

I OECD transfer pricing requirements

  A. Purpose of the report
  B. Business description
  C. Financial results
  D. Functional analysis
  E. Transfer pricing analysis under the OECD Guidelines
  F. Economic analysis
  G. Conclusion

II Local country transfer pricing requirements

Local country transfer pricing legislation

III Annexes

A list of nine sample annexes, mostly based on financial information that should be already available within the company

Recommendations

The first point made by the author at the conference is that a global approach is becoming an absolute necessity for multinationals. Constantly increasing requirements necessarily lead companies in that direction and, as outlined above, the companies who are quite successful in managing their documentation have already adopted some kind of global standard.[1]

Secondly, any type of standard should allow for a certain degree of flexibility. Whatever the model, companies should be allowed to reasonably adapt it to the specific facts and circumstances and be protected against purely formalistic challenges.

And finally, now is the right time to create a panel of companies dedicated to developing a position of multinationals based on their practical experience. The past few years have been rich in developments and experience, and it is very important to capitalize on these experiences to refine the model. This seems to be in line with the ICC policy statement which is a dynamic document that requires periodic reviews.[2]

Conclusions

The ICC model represents a very valuable attempt to define an international standard with these main features:

- Utilization of already existing financial data
- Search for a reasonable and balanced “common denominator” of participating countries’ requirements
- Penalty relief
- Formalization of a practical sample package

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[1] “Successful management” meaning not the simple compliance to documentation requirements; but rather: transfer pricing documentation representing an integrated element of a successful transfer pricing audit strategy.

[2] Practical examples of items that could be reviewed are:

- The description of country transfer pricing rules does not significantly add value to a company’s documentation (this aspects are well know to tax authorities) and requires a relatively significant effort to companies.
- The ICC sample annexes show a segmented reporting view that is not necessarily available in the existing accounts of all companies (ICC is clearly addressing the point that these are samples and data should be taken as available to the company but, still, the samples could be reviewed on the basis of various company’s experience).
- A typical issue on which companies would need help is the materiality of transactions: it would be very helpful to have a recognized standard defining that transaction below a certain level can be just mentioned in the documentation, but not described in details unless this will required during an audit.
- Minority owned entities are also a typical issue and the standards for these entities should take into account the practical difficulties to collect information.

Why does this represent a potential milestone in developing a global model for documentation? Because the main issue that we are going to face in the near future is represented by the increasing number of countries introducing transfer pricing documentation for the first time in their jurisdiction. Many of these countries are relatively small non-members of the OECD, and they do not necessarily feel obliged to adhere strictly to any specific international standard. These countries could require very burdensome sets of documentation to be created in a local language and impose heavy penalties for non-compliance; in practice, this could result in a disproportionate burden for companies, worsened by the fact that local resources to deal with these issues will be scarce. Due to its historical role of providing input to the United Nations, ICC is well positioned to federate as many countries as possible around a global standard that will help both governments and companies approach the subject in a balanced and efficient manner. Still, the magnitude of the challenge can be perceived by simply looking at the list of participants at the Paris conference: almost all of them come from OECD and BRIC countries.

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