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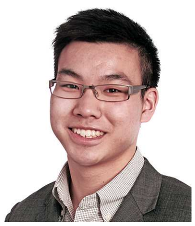
INSIGHT: New OECD Data—Practical Insights for Managing Transfer Pricing Risk—Part 1



BY ANNA SOUBBOTINA AND GARY CHAN

Anna Soubbotina and Gary Chan of Charles River Associates observe that companies are forced to prioritize certain jurisdictions, allocating scarce resources to transfer pricing analyses in jurisdictions which are perceived to be of higher risk. Foreseeing such risk is a complex endeavor requiring consideration of many factors, which the authors group into three categories: local country regulatory requirements; tax authorities' practices and priorities with respect to corporate income tax compliance; and company-specific factors. While the first of the factors is well-documented and available to tax professionals, until now there has been limited objective data to guide taxpayers through the latter two categories, which the authors explore in a two-part series.

In their part-one article, Soubbotina and Chan draw on survey data in the OECD's recently published annual Tax Administration report and look at select data indicators on tax authorities' audit practices. They then apply the data to a hypothetical resource allocation scenario for a sample group of countries. In the second article, the authors will explore the company-specific factors that tax authorities around the world are focused on.

PART I: GLOBAL TAX AUDIT PRACTICES

A new report on global tax administration practices published by the Organization for Economic Cooperation and Development (OECD) enables an enhanced framework for balancing competing priorities in your global transfer pricing strategy. The data in this report (2019 OECD Report), drawn from 58 tax authorities, provide insights into relative levels of enforcement and areas of focus to in-form decisions on where and how to efficiently deploy corporate tax department resources.

As the Covid-19 pandemic continues, almost 200 governments have implemented responses to limit its human and economic impact. Many of these measures impose additional costs on governments already facing historically high levels of debt and declining tax revenue. Since raising taxes during a period of economic decline can be both politically unpopular and less effective, tax authorities are instead likely to step up enforcement. The Internal Revenue Service, for example, increased corporate tax audit rates following the recent Great Recession. Audit rates increased by 45% in 2010-2012 for mid-sized companies relative to 2007-2009.

Transfer pricing continues to be an area of controversy and high compliance cost within the corporate tax arena. Companies are often forced to prioritize and allocate scarce resources to transfer pricing analyses in jurisdictions which are perceived to be of higher risk. Anticipating such risk is a complex endeavor that requires consideration of factors in three main categories:

(1) each country's regulatory requirements with respect to corporate income tax compliance, including transfer pricing;

(2) each tax authority's practices and priorities with respect to corporate income tax compliance, including transfer pricing; and

(3) company-specific factors, such as size, and profitability, as well as location of key functions, risks, assets, and decision makers.

The first of the three categories, local country regulatory requirements, is well documented, summarized, and available to tax professionals. However, there has been limited objective data to guide taxpayers for the

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other two categories. Evaluations of tax authorities' audit practices are frequently based on ad hoc perceptions and anecdotal evidence due to scant objective data to guide taxpayers. This is precisely why the recently published survey data from the OECD are valuable. In this article we analyze select data on audit practices of tax authorities. A second article will look at the company-specific factors that tax authorities around the world are focused on.

A LOOK AT THE DATA

The new OECD data can be used systematically to support executive decision-making around a transfer pricing defense approach and resource allocation. One of the key decisions is whether to invest strategically in transfer pricing defense files upfront, or to prepare compliance-level documentation which satisfies the requirements and focus on defense later in the process (e.g. when an audit is initiated or an assessment is made). Transfer pricing defense files can be designed to support a taxpayer's position with qualitative and quantitative evidence and stand up to scrutiny under audit and in case of controversy. Compliance-level documentation is usually designed just to check the required boxes for annual tax return and penalty purposes.

From a corporate income tax (CIT) and, more specifically, transfer pricing perspective, several indicators in the 2019 OECD Report are informative for business and tax decision makers:

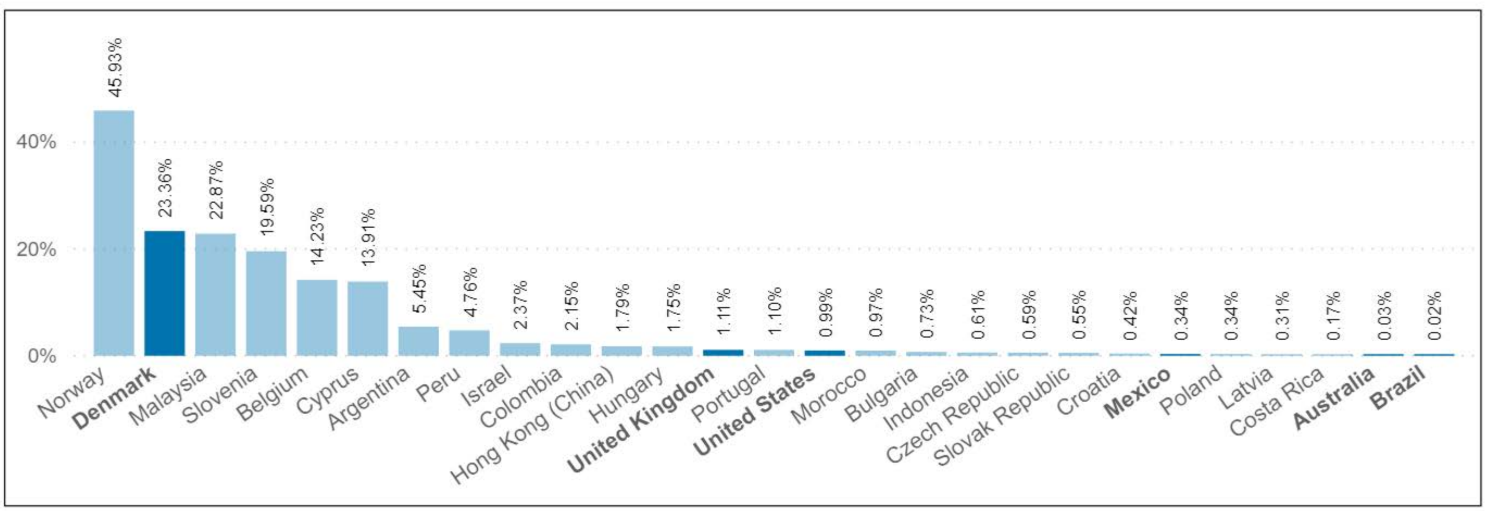
- **Audit coverage**: CIT audits per 100 active CIT taxpayers;
- **Likelihood of assessment**: number of CIT audits where a tax adjustment was made/number of CIT audits completed, and
- **Size of adjustment**: CIT adjustments from corporate tax audits/CIT collected in fiscal year.

We look at each of these data indicators in the following sections and then apply the data to a hypothetical resource allocation scenario for a sample group of countries.

Audit Coverage

Annual data on CIT audit coverage provide useful information when thinking about the possibility of a taxpayer being selected for audit each year. In addition, many tax authorities, including the IRS, publish audit coverage data by taxpayer size and type. As shown in Figure 1, CIT audit coverage rates in 2017 ranged from less than 0.5% per year in Brazil and Australia, to 46% in Norway and 23% in Denmark.

Figure 1: Percentage of Corporate Taxpayers Audited (in %, 2017)



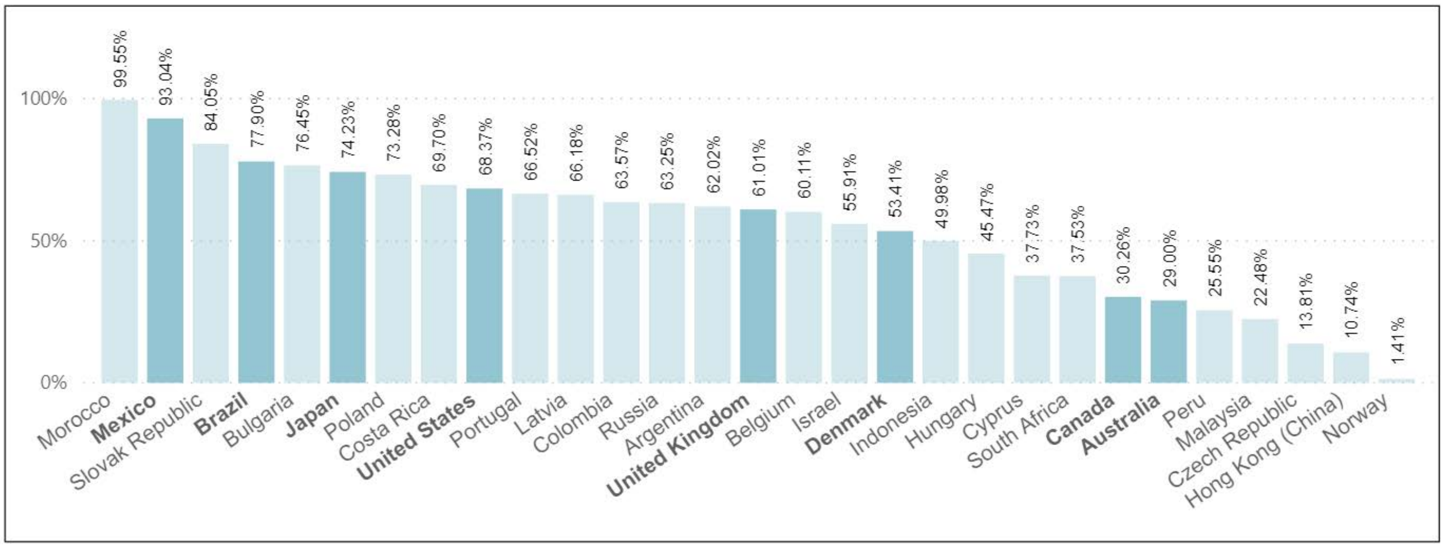
Sources: (i) Tax Administration 2019: Comparative information on OECD and other advanced and emerging economies Annex A Data Tables, (ii) The Fiscal Year 2017 Enforcement and Service Results tables provide details about the number of IRS audits completed, collection activities and taxpayer service. Fiscal Year 2017 began on Oct. 1, 2016, and ended on Sept. 30, 2017.

Among the jurisdictions shown above, Brazil and Mexico, are two of the more critical jurisdictions to be aware of from a transfer pricing perspective. However, only a small portion of CIT taxpayers are audited in these jurisdictions. So, what is going on with the data? It turns out that a critical part of the puzzle is what happens after a taxpayer is selected for audit.

Likelihood of Assessment

Once an audit is initiated, the likelihood of an audit assessment varies greatly by jurisdiction, ranging from low in Norway (<2%) to almost certain in Mexico (>93%). Countries with historically active tax authorities, such as Brazil, Denmark, Japan, the U.K., and the U.S., all have audit assessment rates above 50%. In contrast, Australia and Canada reported assessment rates around 30%.

Figure 2: CIT audits where anadjustment was made /CIT audits completed(in %, 2017)



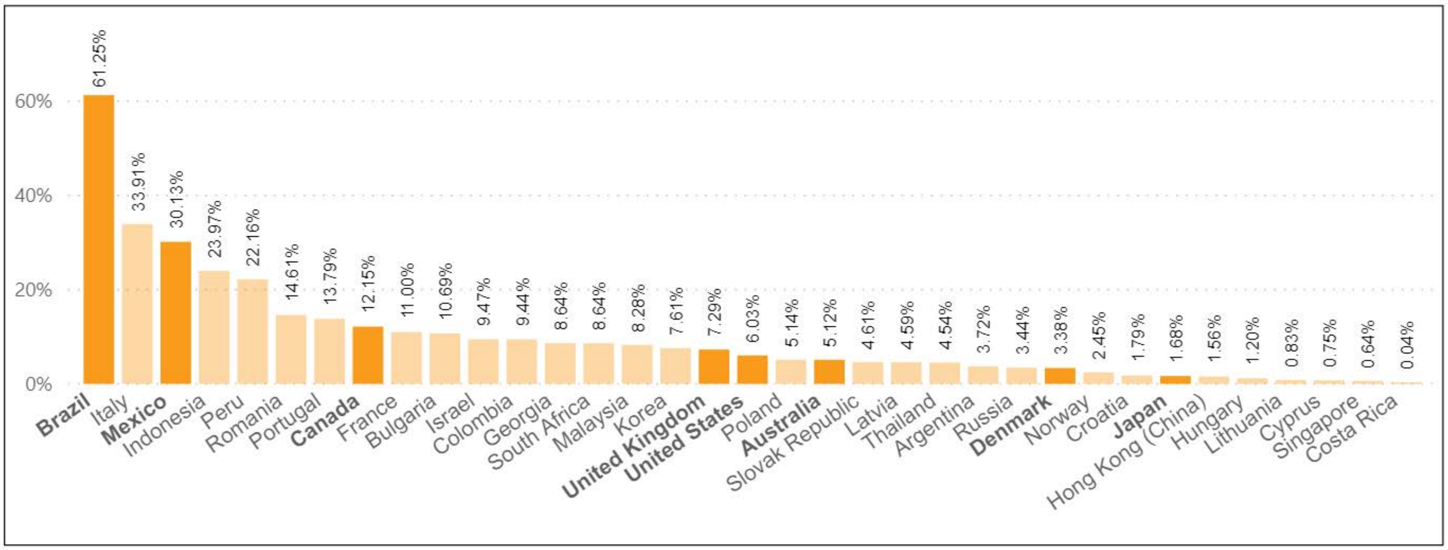
Sources: (i) Tax Administration 2019: Comparative information on OECD and other advanced and emerging economies Annex A Data Tables, (ii) The Fiscal Year 2017 Enforcement and Service Results tables provide details about the number of IRS audits completed, collection activities and taxpayer service. Fiscal Year 2017 began on Oct. 1, 2016, and ended on Sept. 30, 2017.

In totality, the data indicate that once an audit is initiated, there is a better chance of preventing an assessment in some jurisdictions versus others. A multinational company allocating resources between compliance and defense may want to consider which countries are more aggressive in issuing assessments. The next challenge, then, is to weigh the cost of audit defense versus that of potential audit adjustment.

Size of Adjustment

In the same OECD report, we can observe the proportion of CIT collected as a result of audit assessments relative to the total CIT collected (see Figure 3). This could be viewed as an indicator of the relative size of CIT adjustments. For example, Brazil is highly reliant on revenue from audit assessments, as are Italy and Mexico. On the other hand, Australia, which has made headlines for high-profile disputes, has relatively low levels of total CIT assessments to total CIT collected in the 2017 fiscal year.

Figure 3: Corporate Income Tax Adjustment as a Per-centage of Corporate Income Tax Collected (in %, 2017)



Sources: (i) Tax Administration 2019: Comparative information on OECD and other advanced and emerging economies Annex A Data Tables, (ii) The Fiscal Year 2017 Enforcement and Service Results tables provide details about the number of IRS audits completed, collection activities and taxpayer service. Fiscal Year 2017 began on Oct. 1, 2016, and ended on Sept. 30, 2017.

In isolation, each figure presented tells a valuable part of the story. However, a holistic analysis of risk factors is needed to form an effective transfer pricing strategy.

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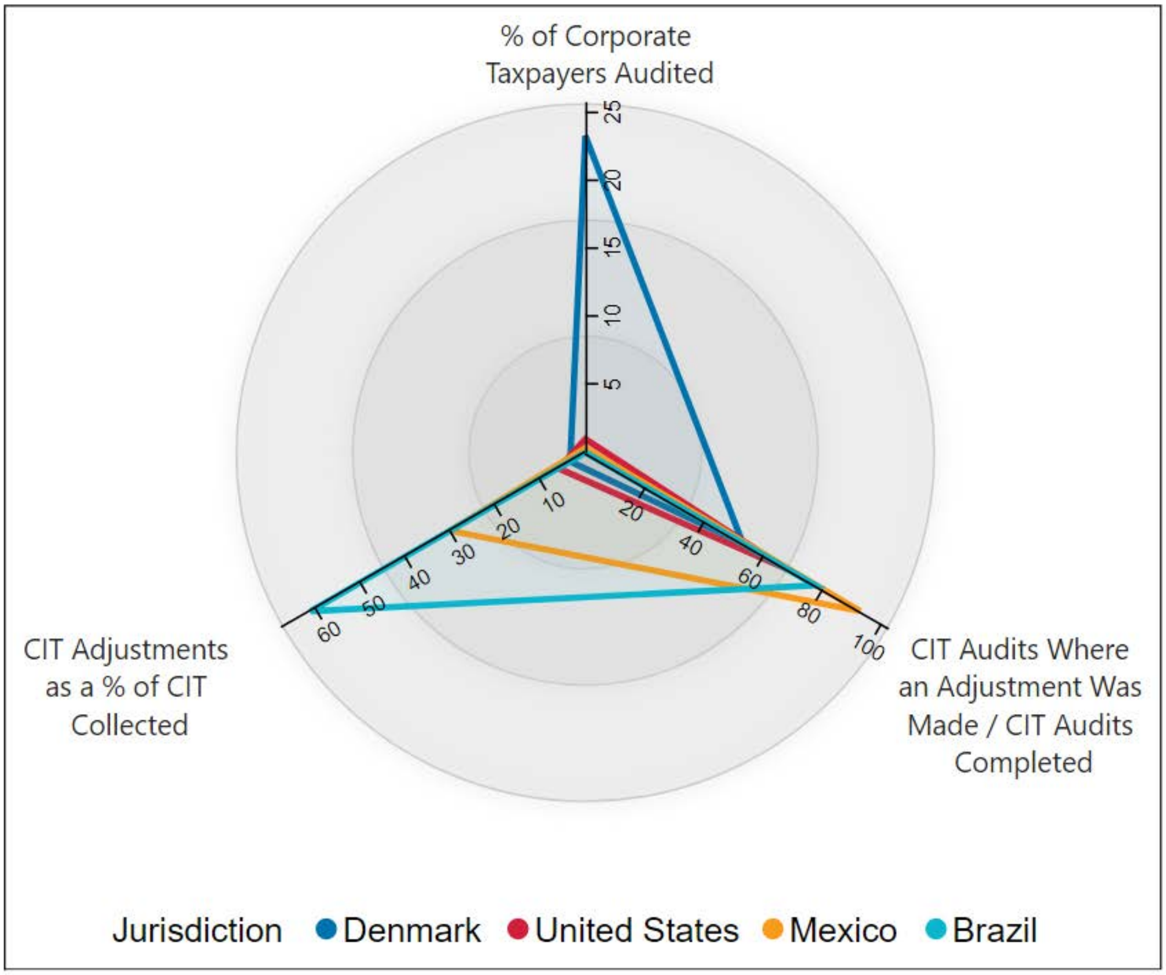
PRACTICAL APPLICATION

Putting the data from Figures 1-3 together, a pattern emerges for each jurisdiction that can help answer the question of how much to invest in transfer pricing defense files upfront, versus spending on defense later, when an audit is initiated, or an assessment is made. Here we selected Brazil, Denmark, Mexico, and the U.S. as sample fact patterns, using the data to illustrate when specific resource allocation strategies may lead to more efficient financial outcomes.

Figure 4: Comparison of Tax Authority Enforcement Approach (Percent, 2017)

The U.S. is well-known among multinational taxpayers and can be used as a baseline for comparison with other jurisdictions shown in Figure 4. Overall in the U.S. in 2017, less than 1% of corporate taxpayers were audited. However, looking deeper into data published by the IRS, it becomes clear that the IRS targets larger corporate taxpayers, with a CIT audit coverage increasing from 4% to 58% among corporate taxpayers with assets of $10 million and up. The majority of audits (68%) resulted in assessments, with adjustments representing 6% of CIT revenue. While transfer pricing documentation is required in the U.S., the data indicate that corporate taxpayers should also be prepared for audit defense.



Jurisdiction	% of Corporate Taxpayers Audited	CIT Audits Where an Adjustment Was Made / CIT Audits Completed	CIT Adjustments as a % of CIT Collected
Brazil	0.02%	77.90%	61.25%
Mexico	0.34%	93.04%	30.13%
United States	0.99%	68.37%	6.03%
Denmark	23.36%	53.41%	3.38%

Sources: (i) Tax Administration 2019: Comparative information on OECD and other advanced and emerging economies Annex A Data Tables, (ii) The Fiscal Year 2017 Enforcement and Service Results tables provide details about the number of IRS audits completed, collection activities and taxpayer service. Fiscal Year 2017 began on Oct. 1, 2016, and ended on Sept. 30, 2017.

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In Denmark, approximately 23% of corporate taxpayers were audited in 2017, with more than half of the audits resulting in an assessment. Therefore, being prepared in advance with robust transfer pricing documentation and audit defense files may be preferable. In the absence of major business changes, much of the transfer pricing analysis can be leveraged across years, with minimal updates. Over the course of three years, chances are good that this documentation will be needed. However, with assessments contributing only 3.4% of CIT revenue, significant upfront investment in local dispute resolution resources may not be necessary.

In Mexico, less than 1% of corporate taxpayers were audited. Based on this, it may seem sufficient to prepare transfer pricing documentation only to satisfy annual compliance requirements. However, once started, 93% of corporate income tax audits result in assessments and adjustments were relatively large, contributing 30% of CIT revenue. Therefore, given limited resources, taxpayers would be well served by preparing for effective audit resolution.

In Brazil, transfer pricing compliance is built into the tax compliance process and diverges from global practices. While only 0.02% of corporate taxpayers were audited in 2017, corporate taxpayers should still be prepared for audit defense, considering that 78% of audits resulted in assessments and the portion of CIT revenue attributed to CIT adjustments (61%) was among the highest reported in the 2019 OECD Report. Historically, navigating Brazil's transfer pricing landscape has required extensive local expertise. Brazil and the OECD have begun exploring options for Brazil to converge with the OECD transfer pricing standards.

As indicated by the significant increase in IRS audit coverage with taxpayer size, factors beyond the data presented in Figures 1-3 should also be considered. Such factors contribute to the final decision of how and when to prepare transfer pricing analyses from a tax technical, business strategy, and budgeting perspective. We will explore such company-specific factors in our second article.

SUMMARY

Transfer pricing stands out as an area of continued complexity and controversy in the international tax arena. A globally consistent and objective framework can help executives strategically deploy more robust transfer pricing analyses to support required compliance documentation. Such a framework can have benefits across the tax and finance organizations, including lower compliance and defense costs, as well as a stronger basis for discussions with tax authorities and financial statement auditors. As demonstrated, the recent OECD Tax Administration report provides new practical insights needed to help corporate taxpayers effectively balance competing priorities on strained resources.

REFERENCES

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Author Information

Anna Soubbotina is a Principal in Charles River Associates' Transfer Pricing Practice and is based in New York. Gary Chan is an Associate Principal in Charles River Associates' Transfer Pricing Practice and is based in Oakland. They can be reached at ASoubbotina@crai.com and GChan@crai.com, respectively.

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