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Toolkit Takes Transfer Pricing Documentation Requirements In the Wrong Direction

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To the Editor:

On January 19 the IMF, OECD, U.N., and World Bank Group (collectively, the Platform for Collaboration on Tax) released an 85-page "practical toolkit" advising developing countries on how to design and implement transfer pricing documentation requirements.[1] (Related story: p. 500.)

Notwithstanding that the toolkit refers many times to the importance of avoiding unduly burdening taxpayers with documentation requirements, it is a hearty endorsement of more annual documentation, on a contemporaneous basis, backed by steep penalties. Regarding penalties, the real action is in Annex 1, in which the toolkit provides a template for implementing legislation. Some of the operative terms are in brackets to signal that they are place holders, but the bracketed terms are likely to be viewed as presumptive or recommended.

Annex 1 calls for a penalty of 2 percent of the underlying transaction volume for failure to prepare and maintain annual, contemporaneous documentation. This penalty applies regardless of whether the underlying transaction was priced correctly.

There is a separate recommended penalty if a taxpayer makes an "incorrect or inappropriate" statement in its transfer pricing documentation or elsewhere pertaining to a related-party transaction. The amount of the penalty depends on whether the incorrect statement bears on the taxpayer's tax liability. The toolkit says that if the "tax liability" of the taxpayer or of an affiliate "computed on the basis of" the incorrect statement is less than "it would have been had the statement not been incorrect," and assuming the incorrect statement is *innocently made*, the penalty for a taxpayer that is a member of a large multinational enterprise (annual revenue of €750 million or more) is 6 percent of the total value of the controlled transactions to which the statement relates, plus 40 percent of the tax liability adjustment.[2]

The penalty is greater if the misstatement is made knowingly or recklessly, while the penalty is reduced if the taxpayer is not a member of a large MNE group. The penalty may be avoided only if the taxpayer can demonstrate that its return position was "about as likely to be consistent with the arm's length principle as inconsistent." There are numerous definitional problems with the toolkit's recommended formulation, but the direction is clear.

A penalty also applies to "incorrect or inappropriate" statements that are "material" but nonetheless do not impact the taxpayer's tax liability. The penalty in this case for a large MNE member is 2 percent of the related-party transaction value if the incorrect statement was innocently made, and higher if the incorrect statement was made knowingly or recklessly. The penalty may be avoided only if the taxpayer can demonstrate that it took "reasonable care" in making the incorrect statement. Only experience will reveal what is meant by that.

The penalty regime contemplated by the toolkit means there is real money for tax

[1] *See* Platform for Collaboration on Tax, "Practical Toolkit to Support the Successful Implementation by Developing Countries of Effective Transfer Pricing Documentation Requirements" (Jan. 19, 2021).

[2] The Annex 1 language is ambiguous and leaves open the possibility that the penalty is limited to the greater of these two figures. The toolkit defines the penalty as the greater of (i) 6 percent of the transaction value and (ii) either (A) 40 percent of the tax liability adjustment or (B) 16 percent of the tax loss adjustment, where (A) and (B) are likely to be exclusive (that is, one or the other). This leaves it unclear whether the toolkit means to compare the penalty under (i) versus the penalty under (ii), or whether it means to compare the penalty under (i) plus (ii)(A) versus the penalty under (i) plus (ii)(B). The connector "and" suggests the latter, which is the interpretation reflected in the text above.

authorities in policing the state of MNE transfer pricing documentation. The tax authority incentive to find fault with the documentation independent of the soundness of the underlying pricing is clear: a new revenue source.

The toolkit evinces unwarranted faith in the notion that annual transfer pricing documentation promotes better transfer pricing compliance. Transfer pricing documentation, the toolkit advises, "can be expected to significantly enhance taxpayer compliance," and annual, contemporaneous documentation best of all.

I'm skeptical.

Transfer pricing documentation is not better for being contemporaneous; it is not better for being annual. Both of these features, coupled with the sheer number of reports required, have turned transfer pricing documentation into a yearlong, never-ending process of paper generation that is delegated, if possible, to junior staff or report-writing programs. It is an annual, nonstop exercise that does not meaningfully spur companies to reflect on their transfer pricing positions.

Periodic transfer pricing documentation requirements — say, every four or five years covering a multiyear period — coupled with sound enforcement techniques, would likely serve the interests of tax enforcement and transfer pricing compliance just as well.

That's not the direction the practical toolkit is pointing. ■

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