

Tax documentation goes global

Documentation and retention
in an era of transparency

Foreword

The thesis of this paper is that, in an era of globally integrated businesses, continuing demands for strong financial performance, and responsible risk management of tax planning and reporting activities, a comprehensive tax documentation and retention policy is increasingly vital for multinational organizations.

“Focus your resources on the business and tax technical issues that add the most value to your business enterprise.”

Various of our recent publications highlight that tax directors face increasing pressures around balancing effective tax planning and reporting¹. Meeting these challenges effectively requires a consistent approach throughout the “tax life cycle” of planning, compliance, financial reporting and tax administrative settlements.

A comprehensive tax documentation and retention policy can enable your entire tax department’s consistency across the tax life cycle. Your focus on tax planning must be demonstrably linked to business purposes. Your tax compliance must be accurate as relates to numerical amounts and required disclosures. Your financial reporting results and judgements must reflect your consolidated and statutory reporting responsibilities – and provide the right starting point for your tax compliance filings. And your effectiveness in negotiating tax administrative rulings and replying to review requests is an important indicator of a constructive relationship with revenue authorities.

A tax documentation policy that has been carefully and sensitively designed to match the organization’s needs and the statutory requirements that apply, will do more than act as an insurance policy, to document

historic activity. It enables the tax department to deliver its responsibilities across the tax life cycle – and best focus your resources on the business and tax technical issues that add the most value to your business enterprise.

This paper sets out what we believe good tax documentation should cover, and what a number of different key jurisdictions require. At present there is no global standard for tax documentation, and the state of play in terms of harmonization does not suggest we will achieve one in the short term. But as accounting standards converge, as tax authorities work ever more closely together on information-sharing and joint enforcement, and as tax policy is aligned by competition for economic and investment activity there is surely an argument for alignment. Transfer pricing documentation has already moved in this direction. There is scope here for key institutions such as the OECD to work with multinational businesses and their advisors to reach an agreement that would provide clarity and certainty in this area. We look forward to the debate.

¹ *Tax Administration Goes Global, Tax Risk Survey, Transfer Pricing Survey.*

Enforcement and information: why documentation matters



Tax documentation has become an important consideration for multinational companies. Over the last few years, tax authorities around the globe have increased the extent to which they coordinate enforcement and share taxpayer information. This is a trend that is increasing as individual jurisdictions buttress their tax enforcement to secure predictable revenue streams to fund government programs and to offset reductions in corporate statutory rates to attract investment.

It is important for companies to understand this broader environmental context and how it reinforces the tax risk-management imperative to maintain good tax documentation. The failure to maintain appropriate tax documentation can be costly. Insufficient tax documentation – the failure to appropriately and timely capture required information and/or the inability to retrieve such information – has been a factor, for instance, in many of the tax-related material weaknesses reported by companies who are subject to Section 404 of the Sarbanes-Oxley Act (SOX 404) in the United States.

Around the world, tax documentation is frequently cited as an important factor, for example, in successfully defending challenges to filed tax returns, in pursuing competent authority resolution in transfer pricing matters, and in maintaining cross-border tax planning structures. In an era in which governments, supported by information-sharing agreements and technology, are working in closer cooperation to streamline global tax enforcement efforts, multinational companies simply have to ensure that systems and controls for supporting their tax positions are up to the task to provide appropriate documentation.

Internationally, regulatory authorities increasingly are recognizing the risks associated with tax reporting and are demonstrating a desire to shine more light on corporate tax functions.¹ Consumers in five of the world's leading economies believe business ethics have worsened in the past five years.² As a result, there is increasing pressure on regulators in many countries to address breaches of regulation and/or public policy. Consequently, many countries are drafting or have adopted rules aimed at improving internal controls over financial reporting and the maintenance of supporting documentation, such as the EU's Eighth Directive, Canada's MI 52-109, and so-called "J-SOX" in Japan International Accounting Standard No. 37 (IAS 37) and FASB Interpretation No. 48 (FIN 48), along with a recent US court ruling regarding access to tax audit work papers by US tax authorities, are examples of a trend toward increased importance of documentation. These and other rules that are part of a growing worldwide body of tax financial reporting regulation invariably affect tax functions. This increased regulation has made the tax function one of the most risk-laden areas in many companies' sphere of activities. Worldwide, the high proportion of reported tax-related material weaknesses and restatements tends to underscore the postulate that tax departments manage an enormous amount of risk.

Globally, companies are showing an increased interest in tax-related risks with good reason. Many multinational companies have identified difficulties in accounting for and documenting income taxes across multiple taxing jurisdictions. Our view is that companies should develop a global program that includes a policy for document creation, retention, maintenance, and training, which may lower the risk of a problem related to tax documentation.

What is "documentation"?

What is meant by the term "documentation"? Is it:

- ▶ Information supporting the tax treatment of transactions?
- ▶ Documents describing tax processes and internal controls?
- ▶ Supporting schedules to tax returns?
- ▶ Research and cites supporting the accounting treatment of tax positions?
- ▶ Third party studies supporting transfer pricing assumptions?
- ▶ Evidence of the operating effectiveness of internal controls?
- ▶ Documents analyzing tax planning assumptions, underlying facts, legality, interpretations, strategies, conclusions, and implementation?
- ▶ Data supporting purchase price allocation?
- ▶ Evidence supporting zero-rated items for value-added taxes?
- ▶ Job descriptions for tax department responsibilities?

Documentation includes all of those items and more. In fact, the term "documentation" is used interchangeably in at least five broad areas that tax professionals may encounter on a daily basis, including:

- ▶ General tax-related policies and procedures
- ▶ Tax accounting support for recorded balances and disclosures
- ▶ Documentation of tax financial reporting processes and related internal controls
- ▶ Tax planning and risk assessment analysis
- ▶ Tax compliance working papers and analysis.

Because the term "documentation" may have different meanings and requirements in each context, the following table may be helpful in understanding the various meanings of the term.

¹ See Ernst & Young's *Tax Administration Goes Global* (2007)

² Grande, Carlos (February 20, 2007, *Ethical Consumption Makes Mark on Branding*. Retrieved 10 October 2007 from <http://www.ft.com/home/us>)

Context	Documentation owner and examples	Purpose/comments	Tax-related Internal control deficiencies
General tax-related policies and procedures	Company management and/or individual process owners <ul style="list-style-type: none"> ▶ Corporate documentation and risk policies ▶ Role definitions ▶ Job descriptions ▶ People <ul style="list-style-type: none"> - hiring policies/minimum qualifications - training ▶ Content, frequency, extent, syllabus, who is to be trained ▶ Procedural instructions, etc that communicate how a position, function or activity is executed 	Management should communicate in writing its policies for tax documentation and retention and for segregating conflicting responsibilities; ensure that consistency in the execution of such policies survives changes in personnel, structure, regulations and technology.	Underlying some tax-related material weaknesses have been a lack of clearly defined tax accounting policies, improperly trained or experienced tax accounting personnel, missing or poorly-defined job descriptions, or incompatible duties.
Support for recorded tax balances and disclosures	Tax accounting <ul style="list-style-type: none"> ▶ Accounting policies ▶ Accounting calendars ▶ Support for recorded balances and disclosures ▶ Memoranda and schedules that document and support evaluation and judgments ▶ Description and schedules supporting accounting treatment of business combinations ▶ Reconciliations and roll-forwards for all tax accounts ▶ Tax return true-up calculation and adjustment, including analysis as to the reason for the adjustment 	Written accounting policies should describe how management's intentions with respect to tax financial reporting are to be carried out in accordance with applicable laws, rules, and regulations. Documentation should demonstrate consistency of accounting treatment with both internal policy and externally reported financial information and should demonstrate, for example, that: <ul style="list-style-type: none"> ▶ Tax balance sheet balances reconcile to a supporting schedule and underlying data; ▶ Deferred tax assets and liabilities are validated based on book-tax basis difference; ▶ Reconciling items are investigated, resolved, adjusted timely; ▶ Tax expense amounts are supported by a rollforward from period beginning to period end; ▶ Disclosures and footnotes agree with underlying memos and calculations; and ▶ Judgments are fully thought out, recorded, factually based, and approved appropriately and on time 	Lack of support for recorded tax account balances and disclosures has been observed as a common cause of tax-related material weaknesses. This has applied to both domestic and foreign tax accounts. In particular, companies that did not maintain a tax-basis balance sheet frequently have required significant effort to correct recorded balances and remediate underlying tax processes



Context	Documentation owner and examples	Purpose/comments	Tax-related internal control deficiencies
Documentation of processes and related internal controls	<p>Tax process owners/internal audit</p> <ul style="list-style-type: none"> ▶ Support for scope determination ▶ Significant accounts, processes, sub-processes, locations ▶ Process documentation consistent with applicable internal control regime. may include: <ul style="list-style-type: none"> ▶ Narratives and flowcharts ▶ IT frameworks ▶ Control definitions and other data describing how processes and controls function ▶ Control documentation ▶ Evidence that a control actually operated the manner it was designed ▶ Testing documentation ▶ Evidence that the test of control was performed 	<p>The company's internal control documentation must be able to demonstrate that it meets the requirements of the applicable internal control regime (EU 8th Directive, SOX 404 etc) . This may include one or more of the following:</p> <ul style="list-style-type: none"> ▶ Significant processes, locations, and risks have not been omitted from consideration; ▶ Relevant controls have been identified for each significant risk and financial statement assertion; ▶ Controls are designed and operate effectively; ▶ Testing results support any assertion regarding control effectiveness <p>Typical components of good internal control documentation include:</p> <ul style="list-style-type: none"> ▶ Process owner/manager; ▶ Important sources of information; ▶ Transaction flow: initiation, authorization, recording, processing, reporting; ▶ Manual versus automated inputs; ▶ Points where data is initiated, transferred, or otherwise changed and where errors could occur; ▶ Important output files, reports, and records; ▶ Functional segregation of duties 	<p>Common areas in which companies have found it necessary to modify tax internal control activities included:</p> <ul style="list-style-type: none"> ▶ Expanding the scope of internal control to include all tax functions where an error of importance could occur; ▶ Inability to provide evidence that key reviews occurred; ▶ Failure to properly reconcile tax provision to filed tax returns on a timely basis ▶ Failure to properly link tax control definitions to related risks and tests where appropriate
Tax planning and risk assessment analysis	<p>Tax function management</p> <ul style="list-style-type: none"> ▶ Data regarding facts and circumstances related to transaction, event, or tax position ▶ Written memoranda or opinion (in-house or third party) regarding technical merits, assumptions based on underlying facts ▶ Discussion of key analyses and judgments ▶ Evidence of 2nd-level review and approval by authorized management 	<p>Tax planning documentation demonstrates that tax planning is conceived and executed in a manner consistent with management's policies and with applicable and enacted laws, rules, and regulations. Tax planning documentation also helps explain how the company arrived at decisions as to how to reflect tax transactions, events, or positions in tax returns and financial statements, and the consideration of potential risks and ongoing monitoring and maintenance requirements as they affect the company from a tax risk perspective, including economic, financial reporting, reputation and other risks.</p>	<p>Failure to properly document, support, and maintain tax planning and controversy resulted in misstatement of tax liabilities has resulted in material weaknesses and restatements for a number of companies.</p>

Context	Documentation owner and examples	Purpose/comments	Tax-related internal control deficiencies
Tax compliance working papers and analysis	Tax compliance manager <ul style="list-style-type: none"> ▶ Support for tax positions taken in returns <ul style="list-style-type: none"> - tax technical analysis - calculations ▶ Data to substantiate that tax return can be tied back to financial records <ul style="list-style-type: none"> - transaction data - balance data - entity hierarchies - and organizational structures ▶ Efiling ▶ Reportable transactions (e.g., under IRC §6011) 	<p>While many companies have compliance documentation procedures, some have not addressed the need for a comprehensive document retention policy. Specialized areas such as VAT and transfer pricing have specific documentation requirements that should be considered for each applicable taxing jurisdiction. Existing documentation policies and procedures may need to be updated to reflect electronic filing requirements. Certain laws, such as the American Jobs Creation Act of 2004 in the United States, provide for stiff penalties for each failure to properly disclose reportable transactions in a company's financial statements.</p>	<p>The following are common internal control deficiencies related to tax compliance:</p> <ul style="list-style-type: none"> ▶ Lack of support for tax-related judgments ▶ Lack of documentation to support transfer pricing activities in all applicable taxing jurisdictions ▶ Failure to analyze or recognize nexus in a jurisdiction ▶ Process for recording the entry to reconcile the recorded income tax provision to the filed tax return did not properly evaluate changes in estimate vs. errors and/or did not record the reconciling entry in the proper period

Risks associated with a tax documentation failure



The potential exposure to such risks demonstrates the need for companies to have a comprehensive tax documentation policy and monitoring program for each of these areas of tax focus.

Every company should assess the need for a comprehensive document creation, retention, and maintenance program that covers, at a minimum:

- Retention policies
- Management
- Storage
- Access and distribution
- Movement
- Monitoring
- Training.

Companies that have written documentation policies should evaluate their sufficiency. Policies should cover the tax areas of focus mentioned previously – accounting and reporting, implementation and maintenance of tax internal controls, tax planning and controversy, and tax compliance. They should also cover matters such as the type and form of documents to be retained, their retention period, acceptable means of storage, who may access and modify tax documentation. Finally, these policies should be formally adopted, communicated, and enforced by company management. Examples of tax documentation policies may include a policy for documenting and sharing tax-related judgments pursuant to IAS37, a policy for the use of maintaining tax data in spreadsheets, or a policy for the form and duration for retaining documents supporting filed tax returns.

Transfer pricing

Companies that transact business across international borders must be familiar with the transfer pricing rules for each country in which they do business. While many countries have formally or informally adopted OECD guidelines, each country's rules are unique with respect to allowable methods, availability of competent authority, audits, and documentation. Not only is familiarity with the transfer pricing rules important to a successful transfer pricing approach, but maintaining proper documentation is equally important. In addition to having a potential adverse effect on available competent authority relief, failure to maintain proper supporting documentation for transfer pricing can result in a multinational company's overpayment of taxes, double taxation and/or, in certain circumstances, significant penalties and interest. However, the maintenance of proper transfer pricing documentation may help avert the assessment of penalties and interest. For these reasons, it is important for global companies to have formal procedures in place to ensure that they understand, monitor, and adhere to transfer pricing documentation requirements for each country in which they transact business.

Area of tax focus

Tax accounting and reporting
Internal controls
Tax planning and controversy
Tax compliance

Potential risk

Financial misstatement
Control deficiencies leading to a material weakness
Loss of tax position, penalties, interest, damage to reputation, anti-shelter penalties
Penalties, interest, loss of business license, officer liability

Tax code documentation requirements in major jurisdictions

Australia

In Australia, Section 262A of the Income Tax Assessment Act 1936 (ITAA 1936) sets forth the principal record-keeping requirements imposed for tax purposes. Section 262A is onerous, requiring records of all transactions and other acts engaged in by the person or company carrying on a business to be held for five years after the records were prepared or obtained, or the completion of the transaction or acts to which those records relate, whichever is later. However, acquisition records may need to be kept longer than the five-year retention period to determine gains or losses on the disposition of assets. Additionally, when an examination is not complete, the five-year retention period may be extended with the Federal Court's approval or with the taxpayer's consent.

All documents that are relevant for any purpose of the ITAA 1936 or the Income Tax Assessment Act 1997 (ITAA 1997) must be retained (e.g., documents necessary for determining the company's income and expenditures, gains on the disposition of property, and penalties). Documents also must be held to show the basis of and method by which an election, choice, estimate, determination, or calculation is reached. If records are held electronically, they must be readily ascertainable in a form that can be understood in English and enables Tax Office staff to determine the company's income tax liability.

The maximum penalty for a breach of Section 262A is a fine of \$3,300. In addition to the penalty under Section 262A, an administrative penalty of \$2,200 may be imposed under Section 288-25 of the Taxation Administration Act 1953 (TAA 1953). As an alternative to imposing an administrative penalty under Section 288-25, a company may be prosecuted under Part III of the TAA 1953. This is limited to serious circumstances, such as reckless or misleading bookkeeping. The maximum penalties under Part III are \$25,000 for a first offense or \$50,000 for a second offense. Directors may also be held personally liable for a maximum penalty of \$5,000 and/or up to two years imprisonment.

The onus of proof in any dispute with the Commissioner rests with the taxpayer even when the Commissioner initiates the process. The standard of proof is "proof on the balance of probabilities," which is difficult for a taxpayer to prove without proper documentation. Record-keeping is therefore important beyond the imposition of penalties.

Further documentation requirements apply to specific areas of tax law, such as capital gains (Division 121 of the ITAA 1997), controlled foreign companies and non-resident trusts (Division 11 of Pt X of the ITAA 1936), substantiation for the purposes of the active income test (Subdivision G Division 8 Pt X of the ITAA 1936), attribution accounts

(Division 4-5 Pt X of the ITAA 1936), and exempting receipts (former Division 6 of the ITAA 1936).

Similar record retention obligations are imposed under the Corporations Act. Under Section 286, companies must keep written financial records that correctly record and explain transactions, financial position and performance, and enable true and fair financial statements to be prepared and audited. Financial records are defined to include source documents such as invoices, receipts, bills of exchange, and working papers needed to explain the methods by which financial statements are made up. Those records must be kept for seven years.

In accordance with Section 344 and Part 9.4B of the Corporations Act, a civil penalty of up to \$1 million may apply in serious circumstances. In addition, a contravention of the financial record-keeping obligation leads to a presumption of insolvency under Section 588E of the Corporations Act.





Brazil

According to the Brazilian federal tax law, every taxpayer generally must keep records as prescribed by the Brazilian Internal Revenue Service (RFB).

According to Decree 3000/99 (Income Tax Regulation), the companies subject to this law must hand over the following books to the Brazilian tax authorities:

- ▶ Commercial books (e.g., journals – art.. 258, general ledger – art.. 259, book of minutes and opinions issued by the supervisory board – art.. 100, Law No. 6404/76)
- ▶ Fiscal books (e.g., inventory ledger – art.. 260, I, goods receipt (purchases) register – art.. 260, II, taxable profit control register – 260, III, permanent inventory register – art.. 260, IV).

Maintenance of Commercial and Fiscal Books (art.264, Income Tax Regulation):

A company should maintain the commercial and fiscal books – documents and papers regarding its business that modify or could modify its equity situation – while the relevant actions are not declared statute barred.

Art.. 195, National Tax Code, provides that the obligatory books must be under the custody of the legal entity until the tax credits from relevant operations are statute barred. As a result, tax authorities rely on the same statutes of limitation for serving a notice of tax assessment based on the accounting and tax records maintained by the company as they do for tax claim purposes (e.g., five years (art.. 174, National Tax Code)). For some taxes, the statute of limitation could be as long as 20 years.

Electronic Bookkeeping: A company is allowed to maintain electronic bookkeeping of its activities and operations. According to art.. 265, Income Tax Regulation, electronic bookkeeping of accounting and tax books is an obligation of companies whose net equity is greater than R\$1.633 million for the immediately prior

computation period and, therefore, they must maintain electronic records open to review by the Brazilian Internal Revenue Service for five years.

If the company does not comply with this rule, it will be subject to a fine in the amounts set forth in art.. 980, Income Tax Regulation:

- ▶ 0.5% of gross revenue, if the format of presentation is not complied with
- ▶ 5% on the amount of the relevant operation in case of omission or error in information requested
- ▶ R\$115 per day, up to 30 days, if the deadline for presentation of files and systems set by the Brazilian Internal Revenue Service is not met.

Canada

Depending on the type of tax in question, Canadian documentation retention standards can vary. For example, the Canadian Income Tax Act (Part XV, Subsection 230(4)) requires taxpayers to retain records and books of account, including electronic documentation, for a minimum of six years from the end of the last tax year to which the records and books relate. The Excise Tax Act also prescribes a similar documentation retention period (Subsection 286(3.1)). In particular, tax returns and documents supporting the numbers contained within the returns should be retained on file by the taxpayer. Additionally, any due diligence performed in connection with transactions undertaken, or opinions received on the likelihood of tax benefits being realized should be maintained throughout the retention period.

Generally, if a taxpayer fails to keep adequate records and books of account, the tax authorities may outline specific documentation standards to be adhered to on a go-forward basis. If the specified documentation requirements are not met, the taxpayer could be subject to penalties. For example, if the proper documentation is not maintained to support income tax

returns as filed, the tax authorities could potentially reassess previously filed returns. In such a case, previously deducted expenses could be denied and the taxpayer could be required to pay tax on the additional income resulting from the denied expenses. Along with additional income tax, the taxpayer may also be subject to penalties associated with not paying the tax liability as and when required, as well as interest on the outstanding tax liability.

For Canadian public companies, inadequate tax documentation may give rise to a deficiency under existing MI 52-109 and the proposed new certification rule NI 52-109. If the deficiency is considered to be greater than inconsequential, the taxpayer might have to undertake remediation efforts to address the deficiency prior to the next fiscal year-end. Additionally, any deficiency or combination of deficiencies determined to be reportable would be required to be disclosed in an issuer's MD&A under the proposed new rule. The new rule is expected to be published in January 2008 and will have an effective date of 30 June 2008.

Similar to the United States, the documentation requirements generally expire with each open audit year.

People's Republic of China

Section 2 of China's Tax Administration and Collection Law (the "Law") governs tax documentation for any taxpayer subject to Chinese tax.

According to Article 17 and Article 18 of the Detailed Implementation Regulations of China's Tax Administration and Collection Law (the "Detailed Implementation Regulations"), taxpayers engaging in production or business operations are generally required to establish and maintain account books including general ledgers, detailed accounts, journals, and other auxiliary accounting records.

Article 21 of the Law specifies that any unit or individual that sells goods, provides services, or receives business services or conducts other business activities should properly handle the issuance, usage, and acquisition of the invoice.

Taxpayers including foreign investment enterprises and foreign companies must keep their account books, vouchers, and statements in Chinese, and at the same time may use another foreign language. Article 29 of the Detailed Implementation Regulations indicates that account books, vouchers, statements, proof of tax payments, tax invoices, and other relevant tax records must be kept by taxpayers for no less than 10 years.

Taxpayers are required to submit the relevant documents regarding the accounting policy, accounting procedures, and the accounting software to the tax bureau in charge. Taxpayers that use an accounting software system should file required documents (e.g., manual processes) with the tax bureau in charge before implementation of the new system.

If a taxpayer fails to maintain proper records, the tax bureau imposes penalties and requires the taxpayer to correct the situation within a certain period of time. If a substantial underreporting of tax is discovered, late payment interest at the rate of 0.05% per day and penalties in the range of 50% to 500% of the taxes overdue can be imposed too. Some serious cases that are defined as tax evasion under Article 63 of the Law may bring about criminal charges according to the relevant criminal laws.

France

Tax documentation requirements in France are limited to tax returns, related accounting records and tax audits. There are no separate rules regarding documentation of tax planning or risk analysis.

The accounting regulations state that:

- ▶ Documentation describing the organization and its accounting procedures must be available in French language (PCG³ art.410.2)
- ▶ Documentation describing the information system and related data processing procedures must be available. This documentation must enable the tax authorities (or the statutory auditor) to perform tests regarding the recording and archiving/storage of journal entries (PCG art.410.4)
- ▶ A traceable audit trail from the journal entry to the supporting documents and vice versa (PCG art.410.3) must be available
- ▶ Each accounting entry must be linked to a supporting document (PCG art.420.3)
- ▶ Account headings and transaction descriptions must be in French.

The general retention period for legal purposes (e.g., dispute resolution) is normally 10 years (commercial code art. L123-22).

In the course of their general tax audits, French tax authorities have access to:

- ▶ All books and documentation held according to the accounting regulations
- ▶ All relevant supporting documentation (invoices, contracts, etc).

The general retention period for tax purposes is normally six years (LPF art. L102 B). However, the statute of limitations is extended to six years beyond the latest carryforward period for tax losses, and the taxpayer must retain the related records during the extended period.

A taxpayer must be able to support every item mentioned in its tax returns subject to a tax audit regardless of the time elapsed since the original entry (reserves, fixed assets, loans, etc).

When accounting records are maintained in electronic files, additional regulations provide that the audit may cover (LPF⁴ art. L13):

- ▶ Information, data, and processing arrangements that lead directly or indirectly to the accounting income, the taxable income, or to any taxable basis
- ▶ The documentation regarding data processing (analysis, programming, execution, etc).

In the event of a tax audit, the tax authorities may request the implementation of specific computer processing (LPF art. L47 A).

There are also specific archiving requirements (LPF art. L102 B) regarding:

- ▶ IT documentation (three-year retention period)
- ▶ Accounting documentation maintained in electronic files (retention period based on the statute of limitations)
- ▶ Basic data and processing (retention period based on the statute of limitations).

³ Plan Comptable Général: general chart of account including accounting regulations

⁴ Livre des Procédures Fiscales : a section of the French tax code dealing with procedural matters



While there is no regulation that specifically requires compulsory and contemporaneous transfer pricing documentation, art. L13B of the French Book of Fiscal Procedures provides that, during the course of an audit, when the tax authorities have gathered evidence leading to the presumption that a company has indirectly transferred profit, they are entitled to request that the company provide data and documents specifying that:

- ▶ The nature of the relationship between the company concerned and related companies operating outside of France or established outside of France
- ▶ The method used to determine the prices of the industrial, commercial or financial operations it carries out with the related companies and the items justifying this method, as well as, where applicable, the remuneration granted
- ▶ The business activities carried out by the related companies relating to the operations referred above
- ▶ The tax treatment reserved for the operations referred to above that are carried out by the related companies in which it directly or indirectly owns the majority or all of the voting rights.

Failure to comply with the above described regulations may lead to certain adverse consequences such as:

- ▶ Transfer of the burden of the proof to the taxpayer
- ▶ Penalties, in the event bad faith or fraud are determined to be present
- ▶ Assessment of a tax equivalent to the related profits earned
- ▶ Other specified penalties.

Germany

Documentation requirements for German taxpayers are defined in Sections 140-148 General Tax Act (Abgabenordnung). The documentation must include all information that is relevant for tax purposes (e.g., accounting, determination of the taxable income, fixed asset valuation).

The record-keeping period generally covers 10 years. Under Section 148(3) General Tax Act, the record-keeping period does not expire as long as the records may become material in the administration of any tax law, i.e., until the statute of limitations expires for the respective fiscal year.

If the documentation requirements are not met, the tax authorities may impose penalties, administrative fines, or estimation of the tax assessment bases⁵ (Section 162(2) General Tax Act) as sanctions depending on the circumstances of the individual case.

As part of digital tax audits, the tax authorities in Germany are allowed to audit taxpayers' accounting records, created with the help of data processing systems, via data access (Section 147(6) General Tax Act). Therefore, taxpayers should maintain tax relevant data in an electronic form and make it available in digital form during the compulsory period of record-keeping (in general 10 years). Thus, the structure and the operation of the respective IT-system must meet the required standard. Failure to fulfil the digital data access requirements could result in the sanctions mentioned above.

Legal documentation requirements for cross-border transactions with related entities are defined in Section 90(3) General Tax Act. Furthermore, Section 162(3) and (4) General Tax Act contains penalty provisions that allow for the levying of penalties if the taxpayer does not comply with the documentation requirements.

In addition to the legal documentation requirements, the Executive Order Law on Transfer Pricing Documentation (Gewinnabgrenzungsaufzeichnungsverordnung-GAufzV) must be considered. That law specifies the type, content, and extent of documentation notes that the taxpayer is required to prepare under the new legislation.

If the taxpayer does not comply with the requirements to prepare documentation notes, the law provides for the following sanctions:

- ▶ The estimation of the tax base
- ▶ The imposition of a penalty surcharge amounting to at least 5% but not exceeding 10% of the income adjustment (€5,000 at a minimum) if no documentation has been submitted or if the documentation is insufficient
- ▶ Delay penalties of up to €1,000,000 are due if the taxpayer fails to submit the necessary documentation on time (in general 60 days upon the tax office's request).

The penalties are non-deductible expenses for tax purposes.

Current legislation, "Reform of Taxation for Businesses and Individuals 2008" (Unternehmenssteuerreform 2008) which still has to be signed by the German President and published in the Federal Gazette before becoming effective, adds transfer pricing approaches to the German Foreign Tax Act (Außensteuergesetz). The transfer pricing approaches are currently only prescribed in circulars of the German Federal Ministry of Finance. The legislation includes several adjustment approaches (e.g., the determination of transfer prices) and a statutory determination of the consequences of a function shift.⁶

⁵ If taxpayers fail to fulfil the legal requirements, the tax authorities are empowered to estimate the basis of taxation. The tax authorities can use internal (e.g., sales of prior years of the respective company) and/or external (e.g., sales of companies of the same branch) comparison values.

With regard to transfer pricing issues, the full range of comparable uncontrolled prices, margins or mark-ups can be used, even to the detriment of the taxpayer (i.e., the most unfavourable prices might be selected for the estimation).

Italy

The Italian legislative system provides two main set of rules on accounting and bookkeeping: the Italian civil code provisions, which specify the books that entrepreneurs must keep and the bookkeeping rules for statutory accounts purposes; and the tax provisions, which specify for direct tax and value-added tax (VAT) purposes, the required books and records and the rules that must be followed to have reliable bookkeeping for tax purposes.

As far as tax rules are concerned, Article 14 of Presidential Decree No. 600/1973 requires businesses to maintain the following records:

- ▶ The journal ledger and inventory book (also required for statutory purposes by art. 2214 of the Italian Civil Code)
- ▶ VAT records
- ▶ An account ledger (i.e., supplementary records, which contain annotated listings of assets and income items, grouped in homogeneous categories)
- ▶ Other minor records that may be required based upon the nature and size of the enterprise.

The books, records, and related documents must be preserved up to the termination of the assessment period for tax purposes (i.e., 31 December of the fourth year following that in which the return for a given year was submitted, in other words, tax records and related documentation for the 2007 tax period must be kept up to 31 December 2012).

Regularly kept books and records are the base for the determination of the Italian taxable income. Tax authorities cannot bypass the data provided by accounting books but can only make tax adjustments on an item-by-item basis. However, if the

books are not properly maintained or there are irregularities that are so serious, numerous, and/or repetitious so as to render the accounting records unreliable, tax authorities are allowed to assess income for tax purposes (Article 39(2) of Decree No. 600/1973, for direct taxes, and Article 55(2) (3) of VAT Decree for VAT).

Italian tax law also provides a fine, ranging from €1,032 to €7,746, for the failure to keep the books as prescribed by the direct tax and VAT provisions (art.9(1) of Legislative Decree No. 471/1997).

The same penalty applies when the books and records are not made available to tax authorities during a tax audit. The indicated penalty is reduced by one-half if the irregularities are not significant, provided that they do not impede the tax audit.

Japan

A corporation may file a "blue" return in the same manner as an individual taxpayer, with the approval of the tax office (Corporate Tax Law 121). A blue return corporation must keep a journal, a general ledger and other necessary books, and record all transactions affecting assets, liabilities, and capital in the books clearly and in good order according to the principles of double entry so that its taxable income can be calculated correctly. The corporation must also (1) settle accounts on the basis of the records; (2) prepare balance sheets, profit and loss statements and other statements; and (3) keep almost all books and documents for seven years (Law 126).

A corporation is required to apply for approval to file a blue return by the day before the first day of commencement of the business year (Law 122). For the first business year of a new corporation, the application for approval must be made by the day within three months from the

date of incorporation or by the last day of the first business year, whichever is earlier.

If the corporation fails to keep the documentation for blue return purposes, the tax office could deny the benefits of the blue returns rule (e.g., carryforward of tax losses).

A corporation (unless it is a blue return corporation, as mentioned above) is required to keep accounting books and record all transactions in the specified simple manner (Law 150-2(1)) and file a so-called "white" return. These books include invoices, receipts, and records of all transactions. The tax office will audit these books in the case of a tax investigation (Law 150-2(2)).

If a corporation wishes to keep documents electronically for tax purposes, the corporation can apply for electronic record retention with their local tax office. Generally, the local tax office will approve the request if the corporation demonstrates that it can keep documents electronically in compliance with the regulations. (Electronic Book Keeping Law 4).

⁶ The term "function shift" is used in connection with a transfer of business functions within a company or an affiliated group. In the event of a shift of business functions,

the taxpayer has to determine the value shift through the valuation of a "transfer package," which would in essence be the discounted value of the transferred earnings potential.



Mexico

Under the Mexican Income Tax Law (MITL), taxpayers must maintain proper supporting documentation of every transaction. Moreover, the MITL provides minimum requirements for bookkeeping, including identifying each transaction. The Federal Tax Code imposes fines if those provisions are not met, creating a potential tax contingency. In general, supporting documentation should be maintained for five years, as of the date when the annual tax return was filed. However, this period may be extended to 10 years, in certain cases, such as for tax years when a loss is created.

In addition, companies must generally prepare financial statements in accordance with the Mexican Financial Reporting Standards to have “appropriate numbers”, obtain financial statements, and an unqualified tax audit report. However, in practice, many subsidiaries of multinational groups will accept a qualification.

If a taxpayer does not comply with the above-mentioned financial accounting and tax obligations, a risk exposure and contingency would exist. Accordingly, the following issues should be kept in mind:

1. Legal and Tax

- ▶ Risk with the Mexican Tax Authorities (Hacienda) whereby periodic reviews and audits could be performed. Fines and penalties (adjusted by inflation and interest) could be imposed due to the lack of proper tax-related documentation.
- ▶ The deduction of expenses (interest, purchases, etc) may be disallowed if formal documentation requirements are not met.
- ▶ Hacienda may make adjustments for presumptive income that could have an effect on the calculation of profit sharing, in addition to the income tax.

2. Accounting

- ▶ Inaccurate financial information could lead to misunderstandings.
- ▶ Failure to appropriately record transactions and the lack of documentation could result in unnecessary and costly burdens.
- ▶ Financial statements and audit tax reports with observations from independent auditor could create an adverse or negative reputation.

It is important to bear in mind the strict nature of the Mexican tax regime (where special consideration should be given to the fact that Hacienda gives special attention to the supporting documentation of each transaction entered into by taxpayers). In most instances, form may prevail over the substance with respect to tax matters. With this in mind, if the Mexican taxpayers fail to have supporting documentation of their tax-related transactions, they could be subject to adverse consequences that could vary from an exclusion of a deductible expense, entailing fines and interest, even criminal procedures.

The Netherlands

For each entity⁷ subject to Dutch tax, art.. 52, paragraph 1 of the General Tax Act (GTA) contains a tax documentation requirement. That paragraph requires each entity to document and retain all information, such as accounting records including additional workbooks and sheets, files, and all other information required for determining the taxable amount and related taxation. Under art.. 52, paragraph 4 of the GTA, the above mentioned information and information carriers (e.g., hard copy or CD-ROM) must generally be retained for seven years. The documentation should be reasonably easy for the Dutch Revenue (the Revenue) to access during the retention period. For some objects of taxation, different retention terms may apply.

For example, the retention period for the Value-Added Tax on real estate is nine years.

If the information is complete, correctly transferred, and still easily accessible, the information may be transferred from one information carrier to another information carrier during the retention period. For example, the information may be transferred from a hard copy file to a CD-ROM or hard disk memory.

If the entity cannot show the documentation as requested by the Revenue, the entity will not meet its legal information obligation, possibly subjecting it to penalties and, potentially, criminal charges. Those sanctions can be avoided if the entity can prove the violation was caused by circumstances beyond its control.

The Dutch transfer pricing legislation requires Dutch entities to produce transfer pricing documentation if they are involved in transactions with associated enterprises. The documentation requirements are described in the third paragraph of art.8b of the Corporate Income Tax Act. That paragraph stipulates that taxpayers are required to include information in their accounting records showing how the transfer prices have been established. Furthermore, such information should enable the Revenue to assess whether the taxpayer's transactions were concluded under arm's length conditions. The documentation is preferably prepared at the moment of entering into the transaction and is required to be submitted at the request of the Revenue. If no documentation is prepared, a company will be granted a period of four weeks (up to three months, depending on the complexity) to do so. If the granted period passes without supplying or incorrectly supplying sufficient information to the Revenue, adverse consequences may apply such as a shift of the burden of proof to the entity or fines.

⁷ And specific individuals (as listed in the Dutch Income Tax Act 2001)

Russia

Russia has a stringent “form over substance” tax environment, with strict documentation requirements being one of its key components. Failure to maintain tax documentation in compliance with the established rules can result in severe tax sanctions and penalties to the taxpayer.

For Russian statutory accounting purposes, Law 129-FZ (On Statutory Accounting) requires that all business transactions must be supported with “primary documents”, based on the templates prescribed by statutory accounting legislation. In fact, each transaction or accounting entry should be reflected in a corresponding primary document in a specific format. Generally, the format of tax documentation is largely driven by the statutory accounting rules, although the focus is on support of deductions and offset of input VAT rather than income or other similar transactions.

Russian tax legislation requires that all tax-related documentation (e.g., tax policies, tax returns, tax registers and calculations, primary documents supporting income, deductions, tax benefits applied and payment of taxes, etc) must be retained for at least four years (Tax Code, art.23, item 1, sub-item 8). However, certain tax-related documents must be retained for a longer period when they are required to support tax calculations for a longer period (e.g., the Russian loss carryforward allowance, which can be carried forward 10 years). The default document retention period for tax documentation is different from the one established for statutory accounting purposes, which requires that all supporting documents must be kept for at least five years.

Tax documentation requirements for Russian income tax purposes are primarily focused on supporting the deductibility of expenses. In particular, the existence of proper supporting documentation is explicitly mentioned as one of the key conditions for their deductibility. Compliance with this requirement is usually the primary area of focus for the Russian tax authorities when performing tax audits of companies, and often expenses are disallowed in practice due to lack of supporting documentation and based on purely formalistic grounds.

VAT is another tax area sensitive to documentation requirements. The Russian VAT legislation provides the specific format for invoices (so-called “factura-invoices”), which are mandatory to support any supply of goods, works, or services between companies. Factura-invoices have a specific format that must be consistently applied. Failure to follow, or minor deviations from, the format are the most common reasons for disallowance of input VAT recovery/offset under corresponding supplies of goods, works, or services by the tax authorities. Additional documentation requirements and specific scrutiny is applied to documentation supporting input VAT recovery on zero-rated (e.g., export) operations. Each package of documents supporting zero-rated supplies is subject to additional in-house tax audit by tax authorities before input VAT related to such supplies is allowed to be recovered from the budget.

Russian tax legislation generally allows taxpayers to maintain tax documentation in electronic form under certain conditions required by the Russian legislation on digital signature. However, paper copies of such documents must be presented to any interested party (e.g., the tax authorities) upon request. For this reason, it is rather uncommon for companies to maintain tax documentation in electronic form.

South Africa

The Commissioner for the South African Revenue Service (SARS) requires that any person who renders a return for income tax purposes, is a vendor for VAT purposes, or carries on any business within the Republic of South Africa for Customs and Excise purposes maintain all records that are relevant to the return submitted or enable the taxpayer to comply with the VAT or Custom and Excise requirements.

Generally, all the records (as per the definitions of the various Acts) must be maintained for a period of five years.

Document retention legislation is governed by Section 73A of the Income Tax Act No. 58 of 1962, Section 55 of the Value-Added Tax Act No. 89 of 1991, and Rule 101 of the Customs and Excise Duty Act No. 91 of 1964.

In terms of the Income Tax Act, “records” includes ledgers, cash books, journals, check books, bank statements, deposit slips, paid checks, invoices and stock lists, and all other books of accounts, as well as any electronic representations of information in any form. The definition of records for each applicable type of tax must be addressed as each has their own specific requirement as to what is required to be retained.



Under the Income Tax Act, if the Commissioner requests information from the taxpayer and the taxpayer fails to produce the relevant records/information, the taxpayer will be guilty of an offence and will be fined R50 per day that the information is outstanding or will be imprisoned for a period not exceeding 24 months on conviction. The penalties in terms of the VAT Act are similar to that imposed by the Income Tax Act.

In terms of the Customs and Excise Act, if a person fails to comply with Rule 101, the person is guilty of an offence and, on conviction, liable for a fine not exceeding R40,000 or treble the value of the goods in respect of which the offense was committed, whichever is the greater, or imprisonment for a period of 10 years, or both the fine and imprisonment and the goods could be liable to forfeiture.

Spain

Any business, whether carried out by a person or an entity, is required to keep all legal documentation (accounting books, correspondence, invoices, tax returns, etc) for a minimum period of six years, as stipulated in Section 30 of the Commercial Code (Basic Mercantile Law for Business Activities).

For tax purposes, and according to General Tax Law 58/2003, Section 70 provides that every taxpayer must keep (1) records (hardcopy or electronic); (2) data and information sufficient to establish the amount of gross income, deductions, and credits; or (3) other information required to be shown in any tax return. Such records and information must be retained for the statute of limitations period of four years. However, because Section 30 of the Commercial Code (Basic Mercantile Law for Business Activities) stipulates a minimum retention period of six years, most companies retain their records and information for that period. Furthermore, for specific tax documents, the tax law requires a six-year retention period.

For individual taxpayers, Section 104 of Law 35/2006 stipulates that all documentation must be kept for the four-year statute of limitations period. If the individual is a business owner, the six-year retention period under Section 30 of the Commercial Code (Basic Mercantile Law for Business Activities) will apply.

Generally, the retention requirements expire with each open audit year. However, under Section 70, retention periods for some records and documents may extend beyond the closure of an audit cycle.

Examples include:

- ▶ All records that support net operating loss carryovers (15 years)
- ▶ Fixed asset records, until the asset is disposed of or fully depreciated.

The most significant consequence of failing to keep the records and documents during the mandatory retention period is that the taxing authority may disallow expenses, tax credits, carryforward losses, etc because the taxpayer will not be able to evidence with documents the amounts shown in the tax returns or in the statutory books. Also, a taxpayer may be subject to a fine for failing to maintain adequate records.

Switzerland

The tax documentation and retention rules in Switzerland are not as extensive as the rules in many other countries. However, taxpayers should consider the following articles of the Swiss tax laws:

- ▶ Direct Federal Income Tax: art.126 par.3 of the law on the federal income tax. The cantonal income tax laws include similar rules. In addition, the Swiss Federal Tax Administration published on 28 January 1980 circular letter no. 2 regarding the obligation of self-employed taxpayers to prepare and retain certain documentation
- ▶ Withholding Tax: art.2 of the ordinance on the withholding tax
- ▶ Stamp duties: art.2 of the ordinance on the stamp duties
- ▶ VAT: art.58 of the law on the value added tax.

Art.126 par.3 of the law on the federal income tax requires taxpayers to store accounting records, receipts, certificates, and other important documents in connection with the business activities for at least 10 years.

In addition, the Federal Income Tax Act and the VAT Act refer directly to art.957 and art.963 par. 2 of the Swiss Code of Obligation, which provide the general rules in Switzerland for the documentation of business activities and the retention of underlying documents. These two articles are further specified in the ordinance on the regulations on keeping and storing the books of account (Geschäftsbücherverordnung).

Generally, a company is required to keep the following documentation during a period of at least 10 years, which begins with the expiration of the respective business year:

- ▶ Balance sheet and profit and loss statement
- ▶ Underlying accounting records/ vouchers/ledgers
- ▶ Important and significant business correspondence.

However, art.58 par.2 of the VAT Act requires a retention period of 20 years for documents relating to real property.

The profit and loss statement and the balance sheet must be signed and kept in hardcopy, but other documents may be retained electronically or in other form, provided that access to those documents is always possible within a reasonable timeframe.

United Kingdom

Any company that is subject to UK corporation tax has a duty to keep and preserve records in accordance with the provisions of Finance Act 1998, Schedule 18, paragraphs 21-23. A company is required to “keep such records as may be needed to enable it to deliver a correct and complete return for the period” (para 21 (1)).

The records required to be retained include:

- ▶ All receipts and expenses in the course of a company’s activities, and documents regarding the matters for which the receipts and expenses arise
- ▶ In the case of a trade that involves dealing in goods, all sales and purchases made in the course of the trade (para 21 (5)).

In both cases, supporting documents are required to be retained, which includes accounts, books, deeds, contracts, vouchers, and receipts (para 21 (6)).

In most cases, records do not need to be retained in their original format. Accordingly, scanned copies, facsimiles, or information stored electronically that maintains the content but not the appearance of the original records is acceptable.

However, in certain limited cases, original records must be preserved (e.g., dividend vouchers and certificates of foreign tax paid) (para 22 (3)).



The basic rule is that records must be retained until the later of:

- ▶ Six years from the end of the accounting period
- ▶ The date after which Her Majesty's Revenue and Customs (HMRC) no longer has power to inquire into the return, and
- ▶ The date after any HMRC inquiry into the return is completed (para 21(2)-(4)).

Public companies are, in any case, required under Section 222(5) Companies Act 1985 to keep accounting records for six years and, therefore, in practice, any additional retention period for tax purposes is likely to be short. However, under the Companies Act, private companies are only required to retain records for three years and, therefore, the above tax-specific record retention provisions impose a significantly longer retention period.

In addition, there are some areas (e.g., transfer pricing and controlled foreign companies) in which records have to be maintained for tax purposes, but not for Companies Act purposes.

Failure to keep records is subject to a maximum penalty of £3,000 per company per accounting period (para 23(1)).

There are limited exceptions in which a penalty will not be levied, such as when the records might have been needed only for the purposes of claims, elections, or notices not included in the return.

In practice, the fixed £3,000 penalty is generally not charged. HMRC, instead, often seeks to levy a tax-gearred penalty (which, at present, can be up to 100% of any understated tax) for filing an incorrect return due to the inadequacy of the underlying information or documentation (para 20).

United States

For any person or entity subject to US tax, Section 6001 of the Internal Revenue Code governs tax documentation. Under Section 6001, every taxpayer generally must keep records as prescribed by the Treasury Secretary. Treas. Reg. § 1.6001-1(a) further provides that taxpayers must include records sufficient to establish the amount of gross income, deductions, credits or other information required to be shown in any return. Such records must be retained as long as they may become material in the administration of any internal revenue law. Treas. Reg. Section 1-6001-1(e). Revenue Procedure 98-25 extends the scope of the federal tax record retention requirements to electronic records. Revenue Procedure 98-25 applies to all systems (i.e., both IT and manual processes) that may have a financial and accounting impact, and any transaction that may have a financial impact. Retention content must include, for example, enterprise, legacy, and interfaced IT system data.

Companies also must recognize that upgrading or abandoning IT systems in favour of new systems without understanding the requirements of Rev. Proc. 98-25 could have adverse consequences. For example, one company had to manually re-create millions of records for a de-commissioned IT system and another company's officers were subjected to civil and criminal penalties.

Additionally, if a taxpayer fails to maintain adequate records, the Internal Revenue Service (IRS) may issue an Inadequate Records Notice letter, which may result in a follow-up examination of the taxpayer's record-keeping. See Rev. Proc. 98-25; IRM 4.10.8.16. Companies who are SEC registrants also risk a SOX 404 material weakness if there is a potential financial statement impact.

Generally, the retention requirements expire with each open audit year. However, retention periods for some records may extend beyond the closure of an audit cycle. Examples include:

- ▶ All records relating supporting net operating loss carryovers
- ▶ Fixed asset records until the asset is disposed of or fully depreciated
- ▶ Records for activities that span multiple years and the ultimate treatment is dependent on future events (e.g., profit and revenue recognition for long-term contracts).

Conclusion

The focus on transparency in tax, as in other financial matters, shows no sign of abating. All stakeholders, including governments, are increasingly demanding to know more about the supporting materials that document tax transactions and tax reporting.



Documentation action plan

- ▶ Understand the areas where tax documentation affects your company.
- ▶ Evaluate the efficacy of existing written tax documentation policies to address and mitigate related risks.
- ▶ Identify areas of tax documentation risk and remediate where necessary.
- ▶ Assign an individual to be documentation monitor and establish an ongoing tax documentation monitoring and maintenance program.

Multinational companies deal with numerous and widely divergent taxation, accounting, and internal control regimes. The current climate in many countries has put tax risk high on the agenda of management, audit committees, and tax directors in many companies as a result of increasing scrutiny by regulatory authorities. Documentation as it pertains to tax functions – accounting, internal controls, tax planning and controversy, and tax compliance – poses a significant, growing, and often overlooked risk to companies, and the consequences of a failure to produce accurate and meaningful tax documentation can be costly.

Each area of focus within companies' tax functions has unique documentation requirements and it is important to have a clear understanding of what documentation is required. Companies should develop a comprehensive program for tax documentation that includes a policy for document creation, retention, maintenance, and training. A comprehensive program will help ensure that management's expectations are carried out and may significantly lower the risk associated with a tax documentation failure.



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To help you meet the challenges of today's complex business environment, including demands for more transparency and greater tax department effectiveness, we provide assistance in three key areas:

- ▶ **Tax accounting** under IFRS or US GAAP
- ▶ **Tax function performance:** improving organizational strategy, processes and data/systems effectiveness
- ▶ **Tax risk:** identifying, prioritizing, monitoring and remediating risk.

Our talented people, consistent global methodologies and tools and unwavering commitment to quality service are all you need to build the strong compliance and reporting foundations, sustainable organizational strategies and effective risk management protocols that help your business achieve its potential. It's how Ernst & Young makes a difference.

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