



ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT



RESPONSE OF THE COMMITTEE ON FISCAL AFFAIRS
TO THE COMMENTS RECEIVED ON
THE SEPTEMBER 2009 DRAFT REVISED CHAPTERS I-III
OF THE TRANSFER PRICING GUIDELINES

22 July 2010



CENTRE FOR TAX POLICY AND ADMINISTRATION

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1. The revision of Chapters I-III of the Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (hereafter “the Guidelines”) has been the subject of an extensive consultation process. Two open invitations to comment were released, one on comparability issues (2003) and one on profit methods (2006). Draft issues notes were then released for public comment on comparability issues (May 2006) and profit methods (January 2008). Detailed contributions were received from the public on each of these four releases and posted on the OECD Internet site. A two-day consultation among Working Party No. 6 delegates, representatives of the OECD Secretariat and the business commentators was held in Paris in November 2008 to consider further the views of the commentators. On 9 September 2009, the OECD issued for public comment a draft of new Chapters I through III of the Guidelines (the “Draft Guidelines”). Numerous written comments on the Draft Guidelines were submitted.

2. Both written and oral comments were considered in detail by the OECD and proved very helpful in revising the Draft Guidelines and in finalising WP6’s work on this project. The OECD is very appreciative of the thoughtful comments that were submitted for its consideration.

3. A brief summary of some of the most important topics raised in these comments and the action taken by the OECD with respect to the comments is set out below. In finalising its revision to Chapters I through III of the Guidelines (the “revised Guidelines”), the OECD attempted to reach a balance between the business comments requesting more detailed guidance and those concerned with the guidance being too prescriptive. A few concerns directly relating to the transfer pricing of intangible property have been deferred to the future project to revise Chapter VI of the Guidelines which is tentatively scheduled to commence in 2011.

4. The revised Chapters I-III of the Guidelines were approved by the Committee on Fiscal Affairs on 22 June 2010. The Recommendation of the Council of the OECD [C(95)126/Final] was amended on 22 July 2010 to reflect this and other changes made to the Guidelines.

I. Documentation and Compliance Burdens on Taxpayers

5. Several commentators suggested that the revised Guidelines should more clearly indicate that compliance burdens on taxpayers should be balanced against the reliability of the transfer pricing analysis. In particular, some commentators suggested that statements at several points in the Draft Guidelines and in other OECD publications relating to documentation were overly prescriptive and reflected a lack of proper balance between compliance burdens and the enforcement needs of tax administrations. The suggestion was made by some commentators that the Guidelines should be treated more in the nature of helpful hints and tips for applying the arm’s length principle rather than as prescriptive guidance.

6. The OECD agrees that it is important to strike an appropriate balance between administrative compliance burdens and the reliability of the transfer pricing analysis as noted in particular at paragraphs 3.80-3.83. Several changes were made in the Draft Guidelines to reflect more clearly the importance of striking a proper balance. However, the OECD does not agree that the Guidelines exist merely to provide helpful hints and tips regarding compliance with the arm’s length principle. Instead the Guidelines are

intended to provide meaningful direction to taxpayers and tax administrators alike as to how compliance with the arm's length principle can be demonstrated in a broad range of factual circumstances and to set out reasonably detailed principles to guide the resolution of disagreements.

7. Particularly as relates to documentation requirements, a number of drafting amendments were made to avoid creating the impression that documentation requirements are created by Article 9 of the Model Tax Convention. The OECD believes that the preparation by taxpayers of appropriately comprehensive transfer pricing documentation is a good practice that can assist taxpayers in their compliance efforts and assist tax administrations in enforcing transfer pricing laws. Moreover, the preparation of documentation provides taxpayers with a useful opportunity to present their views to tax administrations regarding the consistency of their controlled transactions with the arm's length principle. Such presentations can sharpen the focus of the review by tax administrators and narrow the scope for possible disagreement. A taxpayer that prepares documentation contemporaneously with a transaction can only increase the understanding of its transfer pricing positions. When a taxpayer prepares documentation only in response to an audit inquiry from a tax administration, it will not always be clear that a transfer pricing analysis was performed at the time of the transaction. Finally, it is important to remember that the specific required content and timing of transfer pricing documentation are matters properly left to local country law. Whatever is said regarding documentation in the Guidelines is only intended to provide general guidance for tax administrations to take into account in developing their domestic law and to assist taxpayers in identifying documentation that would be helpful in showing that their controlled transactions satisfy the arm's length principle (see paragraph 5.1 of the Guidelines).

II. Selection of the Most Appropriate Method

8. Some commentators suggested modification of paragraphs 2.1 to 2.9 of the Draft Guidelines relating to the selection of the most appropriate transfer pricing method to the circumstances of the case. Commentators suggested, among other concerns, that the language could be read to require detailed analysis and rejection of all alternative methods, that the language could lead to unnecessary conflicts with tax authorities over method selection, and that the language did not give appropriate deference to the taxpayer's selection of a method. Some commentators expressed concerns about the preference, indicated at paragraph 2.2 of the Draft Guidelines, for the CUP method where the CUP method and another method can be applied in an equally reliable manner, and for traditional methods where such methods and transactional profit methods can be applied in an equally reliable manner.

9. After consideration of these comments, the OECD concluded that the language contained in paragraphs 2.1 to 2.9 of the Draft Guidelines accurately reflects its views regarding selection of methods and did not modify the principles contained in those paragraphs. The OECD believes that where a taxpayer or tax administration wants to substantiate the choice of a transfer pricing method as being the "most appropriate method under the circumstances of the case" it would be expected to follow the criteria set out in paragraph 2.2 of the revised Guidelines for selecting that method. In doing so, there is no requirement to perform a detailed analysis and rejection of all alternative methods; usually some methods will be easily eliminated as not being the most appropriate based on simply a high-level analysis of the comparability factors.

III. Use of More Than One Method

10. Many commentators welcomed the language in paragraph 2.10 of the Draft Guidelines suggesting that the arm's length principle does not require the application of more than one transfer pricing method. Commentators suggested that the language of that paragraph be modified in various respects in order to confirm that taxpayers need not document corroborating methods. Some commentators also

suggested that paragraph 2.11 should be deleted or modified as being confusing in light of the statements in paragraph 2.10.

11. Paragraph 2.11 of the Draft Guidelines, which referred to the use of secondary methods to corroborate the results of the primary method, was deleted in finalising the revised Guidelines. The language of paragraph 2.10 was retained without modification.

IV. Pass-through Costs Under a Cost-based TNMM

12. Several comments were received requesting clarification of paragraphs 2.134 and 2.135 of the Draft Guidelines concerning when pass-through treatment is appropriate for certain third party costs in connection with a cost-based TNMM analysis. Several commentators suggested that a reference to the principles contained in paragraph 7.36 of the existing Guidelines would be helpful. Others suggested that an effort to articulate more general principles on this point should be undertaken.

13. The OECD has included a reference to paragraph 7.36 of the Guidelines. In other respects it deems the guidance contained in paragraphs 2.93 and 2.94 of the revised Guidelines to be adequate and believes that this issue must be resolved in each case on a facts and circumstances basis comparing like to like.

V. Use of Profit Split Methods

14. Several commentators expressed concern that the Draft Guidelines would require or encourage broader use of profit split methods, either as the most appropriate method or in order to corroborate the reasonableness of the results obtained through application of another method.

15. The OECD does not intend that the revisions of the Guidelines require more extensive use of profit split methods nor does it believe that the language of the revised Guidelines appropriately can be read to impute such a requirement. Profit split methods need not be applied to corroborate the results of other methods in every case. However, profit split approaches can be useful and can be the most appropriate transfer pricing method in some instances, following the criteria identified in paragraph 2.2 of the revised Guidelines. The OECD concluded that no changes to the substance of the Draft Guidelines were required in this regard.

16. Paragraph 3.5 of the existing Guidelines describes situations where a profit split method may be applied. Some commentators suggested that the Draft Guidelines improperly deleted from those circumstances the situation where transactions are highly interrelated.

17. The OECD considers the question of interrelatedness of transactions to be properly addressed at paragraph 3.9 of the revised Guidelines relating to the aggregation of transactions. Accordingly it did not believe that a change in the language of the Draft Guidelines was required in response to this comment. The revised Guidelines would permit use of a profit split method to test transactions properly aggregated under the principles of paragraph 3.9 if such a method is the most appropriate method under the analysis described in paragraphs 2.1 to 2.9.

VI. Dividing the Combined Profits Under a Profit Split Method

18. Several commentators suggested that the discussion at paragraphs 2.86 to 2.89 of the Draft Guidelines regarding how combined profits should be split in a profit split analysis should be revised. In particular, these commentators believe that the Draft Guidelines overstated the importance of objective allocation keys. They suggested that the language be expanded to give greater recognition to approaches relying on a division of profits based on a subjective evaluation of the contributions of each party.

19. The OECD did not adopt this suggestion. The revised Guidelines indicate that the criteria used to achieve an arm's length division of the profits depend on the facts and circumstances of the case and that it is not desirable to establish a prescriptive list of criteria or allocation keys (paragraph 2.132). The OECD believes that approaches based on subjective contribution analyses are generally less reliable than objective measures and that they can give rise to more difficult controversies.

VII. Emphasis on Comparability

20. Some commentators suggested that the Draft Guidelines placed undue emphasis on comparability. In particular, commentators suggested that the statement contained in paragraph 1.11 of the Draft Guidelines that controlled entities may structure their affairs and enter into transactions that differ from those generally entered into between uncontrolled entities is a correct observation. Such commentators suggested further that this observation requires that methods for testing compliance with the arm's length principle that do not rely on comparables should receive more explicit recognition in the Guidelines.

21. The OECD discussed this comment and concluded that no change was needed to the language in the Draft Guidelines in this respect. The foundation for comparability analysis is the language of Article 9 of the OECD Model Tax Treaty. Where possible, an analysis based on comparable uncontrolled transactions can demonstrate compliance with the arm's length principle. The OECD believes that many cases can be resolved on the basis of an analysis based on comparables. The revised Guidelines expressly and properly recognise, however, that there are cases where the arm's length principle is difficult to apply because of the lack of comparable transactions and acknowledge that the mere fact that a transaction may not be found between independent parties does not of itself mean that it is not arm's length (paragraph 1.11 of the revised Guidelines). In such cases it may be necessary, using the analytical tools, principles, and methods set out in the revised Guidelines, to determine whether the conditions in the controlled transaction are conditions that would have been adopted between independent parties under similar circumstances. Furthermore, it may be appropriate, in relevant circumstances, to use a profit split method with no comparables data.

VIII. Reasonably Reliable Comparables

22. Several commentators expressed concern regarding the definition and use of the term "reasonably reliable comparables" in the Draft Guidelines. These commentators suggested that the definition provided in paragraph 3.2 was confusing in that it was contrary to the common meaning of the term and that it was inconsistent with other statements in that paragraph. It was also suggested by commentators that paragraph 3.3 of the Draft Guidelines regarding subsequently identified comparables was inconsistent with paragraph 3.2.

23. The OECD concluded that the definition of the term "reasonably reliable comparable" would be deleted from paragraph 3.2 and that discussions of the reliability of comparables at other places in the revised Guidelines should reflect the general meaning of the terms utilised without a special definition. Paragraph 3.3 of the Draft Guidelines was deleted. The questions of what constitutes hindsight and of the use made by tax administrations and taxpayers of subsequently identified comparables that were not available at the time of the transaction or of the filing of the tax return will be further discussed by the OECD as part of its monitoring activities.

IX. Conducting a Comparability Analysis

24. Several comments were received regarding the multi-step comparability analysis process contained in paragraphs 3.5 and 3.6 of the Draft Guidelines. One concern expressed was that the multi-step

process outlined would be interpreted by tax authorities as being mandatory or standard, notwithstanding the clear statement that the process is not compulsory. The commentators expressed the view that the process outlined could lead to increases in taxpayer compliance burdens. Other commentators suggested changes in the ordering of the steps. It was also suggested that step 10 relating to implementation and support processes was overly demanding and should not be included as part of the comparability analysis.

25. Changes in the drafting were made to clarify further the intention that the comparability process set out in paragraph 3.4 of the revised Guidelines should be viewed as good practice, but should not be viewed as compulsory. Changes were also made to reflect the intention that there is no requirement for an exhaustive search of all possible relevant sources of information. It is important to recognise, as emphasised in paragraph 3.4 of the revised Guidelines, that outcomes are more important than process and that processes should be tailored to the facts of each case. Changes were also made in the ordering of some steps.

26. Step 10 was deleted. Notwithstanding the deletion of step 10, the OECD believes that monitoring and support processes are an important part of transfer pricing compliance. In particular, paragraph 3.82 of the revised Guidelines, underscoring the importance of such monitoring, was retained. The deletion of step 10 should therefore be interpreted only as clarifying that such monitoring is not *per se* a part of the comparability analysis. The deletion of step 10 is in no way intended to denigrate the importance of monitoring and support activities.

X. Internal Comparables

27. Some commentators suggested that the Draft Guidelines placed too much emphasis on internal comparables and suggested that available internal comparables may not be the most reliable indicator of arm's length transactions in every case where they exist.

28. The revised Guidelines provide a more balanced discussion of how internal comparables may or may not provide the most reliable indication of arm's length transactions based on the facts and circumstances of the particular case.

XI. Sources of Information

29. Some commentators expressed concern over the cautionary language regarding the use of commercial databases contained in the Draft Guidelines. It was suggested that the language of paragraphs 3.30 to 3.33 may be overly negative and cause comparable data taken from commercial databases to be rejected out of hand. Others suggested that in some instances commercial databases may be the only useful source of comparable data. Finally, at least one commentator suggested that the emphasis in paragraph 3.44 on the requirement that a database search be repeatable was not realistic when applied to some useful Internet searches given the continuously changing nature of the Internet.

30. The OECD agrees that in some instances information from commercial databases may be the only available information regarding comparables. It is not the intention of the OECD to preclude the use of such information, only to ensure that such information is used in an appropriate manner and that other available sources of information will also be considered where appropriate. There was broad agreement among the commentators with the statement in the Draft Guidelines that quantity should not substitute for quality when identifying comparable data through a commercial database. Changes in the drafting of these paragraphs have been made to reflect a more balanced viewpoint. The OECD also understands the comments regarding the difficulty in repeating certain Internet-based searches and has modified the language to be clear that in such cases what is needed is adequate documentation of the search conducted so that its results are verifiable (see paragraphs 3.41 and 3.46).

31. Several commentators suggested that the Guidelines should unequivocally reject the use of non-public domain information in all circumstances.

32. The revised Guidelines continue to maintain that it would be unfair to apply a transfer pricing method on the basis of non-public data unless the tax administration is able, within the limits of its domestic confidentiality requirements, to disclose such data to the taxpayer so that there would be an adequate opportunity for the taxpayer to defend its own position and to safeguard effective judicial control by the courts.

33. Several commentators suggested that the draft guidance regarding the use of non-domestic comparables was overly restrictive.

34. The guidance regarding the use of non-domestic comparables was clarified.

XII. Information on the Non-Tested Party; Information on the Foreign Associated Enterprise

35. Several comments were received regarding the discussion at paragraphs 3.20 through 3.23 of the Draft Guidelines of the necessity of considering information regarding both the domestic and the foreign enterprises in the comparability analysis. Some commentators suggested that required information on foreign associated enterprises should be limited to that information that would be available if transacting with an independent party. There were also comments seeking clarification of the nature of the qualitative information referred to in paragraph 3.20 and 3.21 of the Draft Guidelines.

36. The OECD believes that some information on the comparability factors and in particular on the functions, assets and risks of each of the parties to the controlled transaction is needed in order to select the most appropriate transfer pricing method to the circumstances of the case and to apply it. The OECD does not believe that the information demands of a reliable comparability analysis are necessarily limited to the information that one would have regarding an independent party. It therefore did not change the Draft Guidelines to reflect such a standard. The drafting of paragraphs 3.20-3.23 has been modified to clarify the guidance and the reference to qualitative information that had caused confusion was deleted.

XIII. Comparability Adjustments

37. Several commentators addressed the question of comparability adjustments. Some suggested that further detailed guidance on such adjustments would be welcome, including additional examples of how to perform comparability adjustments in practice. Others suggested that in many situations making and documenting such adjustments is unduly burdensome. Still others suggested that the Draft Guidelines were inconsistent in requiring comparables to be rejected for material differences from the tested party and in simultaneously suggesting that comparability adjustments not be made for immaterial differences.

38. The OECD did not consider that further expansion of the guidance on comparability adjustments was warranted at this time. It also did not consider that the general guidance on the materiality standards for adjustments was inconsistent but clarified its drafting.

XIV. Arm's Length Range and statistical tools

39. Commentators expressed several reservations regarding the discussion of the arm's length range at paragraphs 3.54 through 3.61 of the Draft Guidelines. Some commentators found that the Draft Guidelines did not sufficiently acknowledge the broad use in practice of statistical tools and in particular of the interquartile range, while some others thought that the application of any arbitrarily defined range is likely to exclude results that are in fact arm's length. Several commentators found the use of the term "measures of central tendency" to refer both to statistical tools to narrow a range and to various points

within a range (median, mean, etc.) to be confusing. Other commentators objected to the suggestion that adjustments might be made to a central point in the arm's length range (such as the median) rather than to another point in the range to be unjustifiable. Still others found the language in paragraphs 3.60 and 3.61 regarding use of points of central tendency where comparability defects exist to be inconsistent with the guidance in paragraph 3.55 that less comparable observations be discarded and that the range consist of observations of relatively equal comparability.

40. The revised Guidelines acknowledge that statistical tools may, in certain circumstances, enhance the reliability of the analysis and/or assist in the selection of the point in the range to which an adjustment is made. The OECD sought to clarify the discussion of the arm's length range and of statistical tools. Paragraph 3.60 of the Draft Guidelines was deleted and other drafting changes were undertaken to make the discussion more internally consistent.

XV. Year-end Transfer Pricing Adjustments

41. Some commentators suggested that the revised Guidelines should contain more direct guidance regarding taxpayers' year-end transfer pricing adjustments and the recognition of such adjustments by tax authorities.

42. Because both arm's length price-setting and arm's length outcome-testing approaches are found among OECD member countries, it was not possible to provide more detailed guidance on year-end transfer pricing adjustments. Language in the revised Guidelines suggests that competent authorities should use their best efforts under the Mutual Agreement Procedure to resolve double taxation issues arising from different country approaches to year-end adjustments.

XVI. "Typical Practices"

43. There were numerous business contributions describing what is "typically" or "often" done in particular situations relating to location savings, aggregation, database screening, analytical processes, comparability adjustments, the use of ranges and many other areas.

44. While the OECD appreciates the experience of the taxpaying community in all of these areas, the revised Guidelines generally refrain from incorporating such fact-dependent guidance. Whether or not a particular approach is appropriate can only be determined under the facts and circumstances of a particular case. The OECD is concerned that illustrations of "typical" practices, even where such practices might be entirely reasonable in particular circumstances, could be misconstrued as providing prescriptive rules.

XVII. Reliance on the Arm's Length Principle

45. Several commentators welcomed the reaffirmation of the use of the arm's length principle in paragraphs 1.16 to 1.32 of the Draft Guidelines. Other commentators thought that this section of the Guidelines should be expanded and strengthened. Still other commentators expressed the view that formulary apportionment principles would work more effectively than transfer pricing approaches based on the arm's length principle, Article 9 of the Model Treaty, and the Guidelines.

46. The material in paragraphs 1.16 to 1.32 is substantially unchanged from the language of the 1995 Guidelines. This reflects the reaffirmation by the OECD of its commitment to the arm's length principle and agreement that the theoretical principle represented by global formulary apportionment should be rejected.