DRAFT ON TIMING ISSUES RELATING TO TRANSFER PRICING

REQUEST FOR COMMENTS OF THE SECRETARIAT OF WORKING PARTY No. 6 OF THE OECD CENTRE FOR TAX POLICY AND ADMINISTRATION ON CERTAIN TRANSFER PRICING ISSUES

6 June 2012

ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT
CENTRE FOR TAX POLICY AND ADMINISTRATION
REQUEST FOR COMMENTS OF THE SECRETARIAT OF WORKING PARTY No. 6
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ON CERTAIN TIMING ISSUES RELATING TO TRANSFER PRICING

The Secretariat of Working Party No. 6 of the OECD Centre for Tax Policy and Administration requests business comments on certain timing issues related to transfer pricing. In connection with its work on transfer pricing aspects of intangibles and other projects, the following modifications to the Transfer Pricing Guidelines have been discussed by WP6 delegates. The indicated modifications are not agreed by all countries. However, they raise certain difficult issues on which comment by the business community is specifically requested by the Secretariat.

In particular, these paragraphs highlight the fact that OECD member countries follow two different approaches in applying the arm’s length principle. In some countries, an arm’s length price setting approach is followed, pursuant to which taxpayers and tax administrations determine prices on an ex ante basis, based on information that was reasonably available to them at the point in time the transaction was undertaken. In other countries, an arm’s length outcome testing approach is followed, pursuant to which taxpayers and tax administrations test the actual outcome of their controlled transactions, on an ex post basis, to demonstrate that the conditions of those transactions were arm’s length. Such testing is generally undertaken at the end of the relevant year or at the time the tax return is filed.

The existence of these different approaches to applying the arm’s length principle raises a number of difficult issues. These include:

- Issues related to the nature of the information regarding potentially comparable transactions that may be relied on by taxpayers and / or tax administrations in applying the arm’s length principle, particularly as it relates to the time at which such information must be available to taxpayers and tax administrations in order for the information to be utilized in a transfer pricing analysis.

- Issues related to the making of taxpayer initiated adjustments to prices reported by taxpayers in their books either at year-end or when filing a tax return, in order to conform their prices and financial results to the requirements of the arm’s length principle. A specific question is whether such adjustments will be respected by all affected countries.

- Issues related to the ability of taxpayers and tax administrations to consider information on post-transaction date developments in assessing the reasonableness of comparability adjustments and financial projections.

- The nature of the Guidance that can be provided in Chapter VI of the Guidelines on situations where valuation of intangibles is highly uncertain as of the date a particular controlled transaction occurs (see paragraphs 6.28 to 6.35 of the Guidelines). Specifically, questions arise regarding the circumstances, if any, involving situations of transfers of intangibles of highly uncertain valuation (other than those specified in paragraph 1.65 under which the actual structure of a transaction may be disregarded) in which tax administrations should be permitted to assume the existence of a renegotiation, price adjustment clause, milestone payment, or other risk sharing mechanism within an agreement between controlled parties which does expressly contain such a mechanism.

In discussions of these issues, it is often suggested by countries taking one or another approach that their approach provides certain fairness related advantages to business. Those favouring an ex ante approach may suggest that their views are favourable to business because they require only what business would have to do in transactions with unrelated persons. Those favouring the ex post approach argue that their approach is more favourable to business because it is flexible and allows business the ability to adjust their results to contemporaneous third party outcomes as those outcomes become known.
It is also the case that views on these issues affect country perceptions of other actual and potential provisions of the Guidelines. These issues include some provisions of the recently released Discussion Draft on the Transfer Pricing Aspects of Intangibles. For example, some countries are less willing to accept valuation techniques based on financial projections if the Guidelines take a restrictive view of the information that may be used to test the reasonableness of the projections or of the ability of tax administrations to impute renegotiation clauses or other risk sharing mechanisms to address the uncertainty of the valuation.

It would be very helpful to the Secretariat to have comments from the business community on the practical problems caused by the existence of these two different approaches. While comments are requested on the potential changes to the Guidelines set out below, the Secretariat also requests broader comment on the compliance difficulties that businesses encounter as a result of the two different approaches to applying the arm’s length principle described above, and whether those differences give rise to double taxation in specific instances, and on the effectiveness of the provisions now contained in paragraphs 6.28 – 6.35 of the Guidelines. Suggestions for practical steps that could be taken to resolve any observed difficulties are welcome.

3.67 Timing issues can arise in comparability with respect to the time of origin, collection and production of information on comparability factors and comparable uncontrolled transactions that are used in a comparability analysis. See paragraphs 5.3, 5.4, 5.5, 5.9 and 5.14 of Chapter V for indications with respect to timing issues in the context of transfer pricing documentation requirements.

3.68 In principle, information relating to the conditions of comparable uncontrolled transactions undertaken or carried out at the same time during the same period of time as the controlled transaction (“contemporaneous uncontrolled transactions”) is expected to be the most reliable information to use in a comparability analysis, because such information reflects how the prices and other conditions that independent parties have behaved in an economic environment that is the same as the economic environment of the taxpayer’s controlled transaction. It is therefore important in conducting a transfer pricing analysis to identify and use information that is as contemporaneous as possible to the controlled transaction, taking into account practical constraints created by the availability and collection of data. Availability of information on contemporaneous uncontrolled transactions may however be limited in practice, depending on the timing of collection.

3.69 In some cases, taxpayers establish transfer pricing documentation to demonstrate that they have made reasonable efforts to comply with the arm’s length principle at the time their intra-group transactions were undertaken, i.e. on an ex ante basis (hereinafter “the arm’s length price-setting” approach). Based on information that was reasonably available to them at that point. Where such an approach is followed, pricing determinations should be based on information that was known or reasonably foreseeable by the associated enterprises at the time the transaction was entered into. Such information includes not only information on comparable transactions from previous years, but also information on economic and market changes that may have occurred between those previous years and the time at which the controlled transaction was undertaken, as well as information on economic and market changes likely to occur after the time the transaction was undertaken, that could have reasonably been anticipated at the time the transaction was undertaken and that would have affected the pricing that would have been agreed between independent enterprises in similar circumstances. In effect, independent parties in comparable circumstances would not base their pricing decisions on historical data alone.
3.70 In other instances, taxpayers might test the actual outcome of their controlled transactions to demonstrate that the conditions of these transactions were consistent with the arm’s length principle, i.e. on an *ex post* basis (hereinafter “the arm’s length outcome-testing “approach). Where such an approach is followed, pricing confirmations should be based on information available at the time the tax return is prepared, providing such information is related to the outcome of comparable uncontrolled transactions undertaken at the same time as the controlled transaction, or prior to the controlled transaction, where suitable comparability adjustments are made to reflect economic changes that occurred between the time that the comparable transaction was undertaken and that at which the tested transaction was undertaken. Such test typically takes place as part of the process for establishing the tax return at year end.

3.71 Both the arm’s length price-setting and the arm’s length outcome-testing approaches, as well as combinations of these two approaches, are found among OECD member countries. The issue of double taxation may arise where a controlled transaction takes place between two associated enterprises where different approaches have been applied and lead to different outcomes, for instance because of a discrepancy between market expectations taken into account in the arm’s length price-setting approach and actual outcomes observed in the arm’s length outcome-testing approach. See paragraphs 4.38 and 4.39. Competent authorities are encouraged to use their best efforts to resolve any double taxation issues that may arise from different country approaches to year-end adjustments and that may be submitted to them under a mutual agreement procedure (Article 25 of the OECD Model Tax Convention).