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Introduction

Ernst & Young is delighted to have this opportunity to comment on the comparability issues encountered when applying the transfer pricing methods recommended in the OECD Transfer Pricing Guidelines (“Guidelines”).

Although transfer pricing is a global issue, Ernst & Young believes that there are significant regional, and national, variations in the availability of data and practice on comparability issues and, indeed, on the application of the OECD Guidelines as there can be significant differences in statutory requirements or administrative practices amongst OECD members. In addressing the questions raised in the OECD’s invitation for comments on comparability issues, we have consulted Ernst & Young transfer pricing practitioners in the Americas, Asia and Europe. Our comments therefore represent a global perspective. In addition, where relevant, we present comments on issues of particular importance in one of these regions and, in some cases, in specific OECD countries.

Overall Perspective on the Applicability of Information on the Financial Performance of Third Party Enterprises (“Comparables”) in Implementing the Arm’s Length Principle

Comparables play a central role in transfer pricing; both in defining and implementing arm’s length transfer pricing policies and in documenting the application and results of those policies in a particular period.

However, in our experience it is rarely if ever possible to identify comparables which meet and can be shown to meet the rightly exacting standards of Chapters 1 and 2 of the Guidelines. There is a major disconnection between the transfer pricing methods described in the Guidelines and taxpayer practice. Internal comparables are often not available and, where they are, rarely capable of adjustment to the standards necessary to rely on them as a principal method or benchmark. As regards external comparables, there is only very limited information available to apply the transactional methods and TNMM as defined in the Guidelines.

The barriers to the effective application are well-known to practitioners but are so fundamental that they deserve to be confirmed as a point of departure.

The Structure of the World Economy Means that There are Ever Fewer Unrelated Party Transactions or Functionally Comparable Independent Companies to Provide a Basis for Comparability Analysis

The structure of the world economy features a high and increasing level of globalisation. As a result, there are fewer and fewer independent companies facing economic and business conditions and with a functional profile, similar to those of entities within MNE’s.

The Multinational Companies Tend to Engage in Transactions within the Group that are Distinctively Different from those between Independent Companies

MNE's exist to the extent that vertical integration across the value chain is an efficient form of economic organisation. An increasingly common way of achieving efficiencies is to streamline the business model by adopting processes and management and control mechanisms which are integrated as seamlessly as possible across international and therefore fiscal borders. The resulting relationships between legal entities are often therefore of a fundamentally different character to those which can be negotiated between unrelated parties. Almost by definition, it is not possible to identify good comparables.

Only Very Limited Information is Available to Evaluate Comparability

As already noted, Chapter 1 of the Guidelines establishes strict comparability criteria. In practice, although the emergence of the internet has improved the position significantly, the information needed to apply these criteria is not available. The strategy, functional profile and contractual terms of potential comparables are all obscure on the basis of public domain information. This is partly related to varying disclosure requirements. However, even in jurisdictions requiring high levels of disclosure, the information available is less than is required to undertake a full comparability analysis; and the cost of undertaking such analysis is a further barrier.

In this regard, it is important to recognise that much greater information is available on companies regulated by the US Securities and Exchange Commission than on other entities.

Differences in Accounting Policies Make Cross Country Comparisons Difficult

The absence of global accounting standards severely restricts the feasibility of analysing gross profit level data across companies as the consistency of data reported at this level can not be assured. As a result, it is rarely if ever possible to apply the C+ and R- methods properly as intended by the OECD guidelines. Unfortunately, it now appears that even a profits-based approach may not be sufficiently insensitive to differences in accounting principles. For example, it has become apparent that some companies include amounts in gross revenues that might be treated as expense recoveries in others; another example is the determination of the appropriate asset base where one company securitizes assets or defeases liabilities when another does not.

Overall, it is our experience that the barriers to obtaining information on companies of sufficient reliability are very considerable and the compliance cost for tax payers is high as a result.

Issue: COMP 1 – Requirement to perform an analysis of transactions vs. an analysis of third party information gathered at company level

There are limited potential sources of transaction-specific third party data; these include: internal comparables (transactions between the MNE and third parties) and external comparables including published price lists and terms of trade, regulated prices, commodity and similar exchanges, and, possibly, court documents. Third party transactional data is generally very fact or product specific or relates to a different level of trade and therefore is unsuitable for transfer pricing purposes except in very limited circumstances.

Other public data, such as company financial data, is frequently relied upon for application (or testing) of transfer pricing in accordance with the Guideline requirements using profits-based transactional methods. To our knowledge, national statutory disclosure requirements and GAAP (“generally accepted accounting principles”) very rarely prescribe disclosure of transactional information by companies. As a result, hardly any transactional financial information is available in the public domain so that traditional transactional methods can rarely be applied or tested in the public domain.

In practice, third party data at company level are generally used to evaluate or establish arm's length transfer prices; this data is, of necessity, very high level and aggregates a large number of individual transactions. Furthermore, such data is often consolidated and may reflect a diversity of business and economic circumstances. Therefore, we believe that it is important that appropriate care be taken, where possible, only to utilise independent companies that have focused business scope, i.e. their operations are not likely to include transactions, business circumstance or intangibles that are significantly dissimilar to the related party transaction in question. Provided such companies can be identified, we consider that they can be used as benchmarks for testing arm's length prices on an aggregate basis.

The necessity of relying on company information is recognised by most tax authorities. However, some use the inherent unavailability of transactional data as a reason for adopting "secret comparables", thereby placing the taxpayer at an unreasonable disadvantage.

As a practical matter, it is therefore necessary to rely on information reflecting aggregated third party transactions; and it would be helpful if the Guidelines were to recognise this. Therefore, the Guidelines should expand upon the comparability factors that it considers relevant to this approach.

Issue: COMP 2 – Need to rely on transactions that took place between independent enterprises

It is a question of fact whether the third parties have complied with the arm's length standard in their intercompany transactions. However, where transactional profit methods (particularly the TNMM) are used, it is possible to use consolidated accounts of third party companies for comparison purposes provided that the functions, assets and risks of the consolidated entity otherwise meet comparability standards

As a matter of general principle, it must be recognised that evidence derived from transactions between related parties cannot be regarded as arm's length and therefore that transactions between members of a MNE must be used with caution as there can be no assurance that such transactions fully comply with the arm's length standard. That said, the scarcity of information on uncontrolled transactions between unrelated parties suggests that no source of information should be rejected categorically. The challenge is to identify the best possible sources of information and evaluate them rigorously. However, it is rarely the case that information derived from related party transactions is likely to be acceptable as a sole benchmark.

Again, there is a risk that acceptance of related party comparables will lead to the adoption of "secret comparables" by tax authorities. The use of private information derived from the related party transactions of one taxpayer in a controversy with another is wholly unacceptable.

Overall, related party information should only be used in exceptional circumstances when it is equally available to the taxpayer and tax authorities and where it can be shown that no independent benchmarks exist. One example would be a case in which it can be shown that a subsidiary of an MNE possesses very specific assets and undertakes activities that are unrelated to other parts of the MNE, and where it is possible to obtain segmented financial reporting (because regulations require such reporting) so that the resulting comparables could provide a more reliable indicator of arm's length pricing than focusing only on independent enterprises that could only be accepted by substantially loosening other comparability criteria.

Issue: COMP 3 – Need to obtain third party information relevant to the review of the five comparability factors

Please see the introduction for our practical experience on this point. In particular, we would point to the inherent difficulty of obtaining information on strategies and contractual terms and conditions (matters of

very major influence on pricing and other commercial terms at arm's length) simply because of the commercial sensitivity of this type of information.

In our view, it therefore is only possible, if at all, to apply the five comparability factors prescribed by OECD guidelines at very significant cost. The cost of a full documentation study for a taxpayer with transactions involving a number of jurisdictions will be measured in units of Euro hundred thousand. A transfer pricing design study involving complex transactions, which necessarily must address other important tax issues, may cost several Euro million.

Issue: COMP 4 – Need to ensure objectivity of the list of external comparables

The selection of comparables is a matter of art as well as science. This is necessary in order obtain a balance between ensuring that all potential relevant external comparables are considered and having a set of potential companies that is manageable for research.

From a global (or indeed local) perspective, the initial automatic screening of information contained in commercial databases can easily lead to thousands of companies requiring further research. The screening capabilities of database are used when it is clearly not practical to research huge amount of companies. In practice, we aim to research a panel of companies in the low hundreds.

In demonstrating the objectivity of the screening process, it is helpful to document the criteria that have been adopted and the effects that the application of those criteria has had on the panel of comparables. When a case can be made for a narrower or broader sample, it is also useful to report a financial analysis for several sets of comparables.

Issue: COMP 5 – Determination of the years to be covered and use of multiple year data

As a matter of principle, it is desirable to take account of experience over the business cycle for the industry in question and relevant developments in that industry. However, our practice is to use the latest available information and to use three years of data unless it can be shown that the years for which data are available are unlikely to be representative, e.g. when a year in question included an on-set of recession.¹

Certain national transfer pricing regulations have provisions on the years to be covered and some times allow for the use of single year only if the quality of comparable companies considered be of high degree of comparability. For example, whereas data relating to the year in question would almost invariably be used in US documentation studies relying on US comparables, this is not possible in Europe where the lag in data availability is much greater.

As to retroactive adjustments, there is an argument to be made in principle that they do not comply with the arm's length standard because independent parties typically agree about prices in advance, i.e. before the transaction takes place. However, if taxpayers clearly and unambiguously agree about arm's length price adjustment mechanisms in advance this should be in line with the arm's length principle.

Some tax authorities take this position, while others are more pragmatic.

¹ If it is clear that a different period is more representative or relevant in a particular set of circumstances, we adjust the period covered by the data appropriately.

Such differences place the taxpayer in a difficult position. It therefore would be very helpful in practice if tax authorities could reach agreement on how to deal with retroactive adjustments.

With regard to the use of multiple year data it would be helpful if the OECD would provide some guidance on the number of years to be considered and the way this data has to be combined or averaged because there are obviously different views on that within OECD countries. From a practical point of view there must be one standard.

Recently, we have found that many companies that are used as comparables have restated their previously issued public financial statements. This trend is most disturbing as it suggests that the reported accounts and statistical data derived from them are suspect. It is uncertain whether consequential changes in the third party observed range due to such restatements may require retroactive adjustments of the tested party.

Issue: COMP 6 – Choice of relevant sources of information, including but not limited to commercial database

The primary advantages in the use of commercially-available databases relate to the efficiency/speed and cost-effectiveness of their use, in particular the ability to

1. access large/centralised volumes of data in electronic format;
2. use the built-in search and interrogation capabilities because
 - a. the data has been classified and summarised (eg, trade descriptions);
 - b. inconsistencies in the financial reporting formats have been ironed out by reclassifying the financial information to a consistent format
 - c. the built-in software/search engine allows Boolean logic to be used in developing a comprehensive search strategy
 - d. the results can be displayed relatively quickly and the information exported to other document formats for further investigation / manipulation

The main disadvantages of commercially available databases relate to

1. inaccuracies in the classification of companies
2. changes in the use of classification structures, and changes in the classification of individual companies, which means that there can be significant differences in each monthly edition of the database, and limits the ability to compare results over time
3. loss of detail in financial statements due to the need to conform to a consistent standard.

Non-electronic data sources may of course be used where available. However, the costs of using these repositories is generally prohibitive.

As a practical matter, commercial electronic databases are therefore very widely used and this is one of the most important reasons for the almost pervasive adoption of TNMM or CPM.

In our experience, where national data are not available, data from differing geographies may be used (for example, in Europe, taxpayers may use a pan-European search or information on specific economies that are deemed as comparable. In other countries US data may be used).

In some cases, economic adjustments are made to company data from third country or regions to account for the economic differences. There is no recognised single best approach in making these adjustments.

Private data bases may be used in certain situations. For example, E&Y maintains a data base of licensing agreements that have been filed as part of public disclosure statements. See also COMP 1 for alternate sources of data.

Issue: COMP 7 – Definition of comparability adjustments where they are appropriate

In some discussions, attention tends to focus on adjustments for differences in asset intensity. This is perhaps because the data are available rather than because there is a persuasive economic case for such adjustments.

However, as a matter of principle a vast range of adjustments may be appropriate, including:

1. National economic factors such as demand and exchange rate shocks;
2. Differences in strategy, eg niche market vs cost leadership, which could influence margins;
3. Differences in the assignment of key business risks, eg volume risk for manufacturers in cyclical industries;
4. Differences in the allocation of key functional responsibilities such as marketing in consumer goods.

The nature of the appropriate adjustments which are appropriate will vary widely from case to case; as will the feasibility of making them.

This diversity means that, in our view, it is not possible to develop useful guidance on when adjustment should be made and the nature of any such adjustments.

However, it would be helpful to establish a clearly stated principle that a taxpayer should take reasonable efforts to adjust for comparability differences in the light of the information available. This could be supplemented by discussion of why adjustments are important in the application of the arm's length principle.²

Issue: COMP 8 – Interpretation and use of data collected

As a matter of general principle, the arguments for restricting the range of experience deemed to be arm's length is dubious at best. However, our experience is that the ranges obtained from a benchmarking study can be very broad. Fundamentally the use of a safe harbour (such as the interquartile range) is flawed as it suggests that the excluded portions of the arm's length comparables fails to achieve arm's length results;

² Under general principles of comparability, adjustments must be capable of reliable determination. Some jurisdictions consider that significant adjustments are indicative of lack of comparability.

therefore the decision to prescribe the use of a particular subset of comparables should not be taken lightly. Furthermore, this should not prevent tax payer making a reasoned case for using the full range.

Moreover, we believe that a disciplined qualitative analysis of the business and industry, their respective strengths, weaknesses, threats, opportunities and strategies, may assist in the selection of comparables and placing the tested party within the range.

The breadth of the range resulting from comparables, particularly if observations outside the inter-quartile range are admitted, suggests that taxpayers should consider a corroborative analysis. This might include reporting the implied transactional profit split.

We caution against indiscriminate broadening of the comparable set to get as large a same as possible to achieve a law of averages. It is our observation that financial ratios vary by industry sector – something that would be lost if a very broad set of ‘comparables’ were used simply for the sake of obtaining a ‘normal return’.

The principle that the tax payer should use all relevant information suggests that there should not be overriding rule on the inclusion or exclusion of loss making comparables. Indeed, it is worth recalling that, fundamentally, it is the facts and circumstances surrounding the company in question that should determine its status as a comparable; not its financial result.

However, it does seem to be appropriate that persistent loss making companies be investigated to establish whether they should be eliminated as non-comparable for some reason. For example, investigation sometimes shows that they are not in fact independent (for example, the weakness of data in Europe and many other regions means that it is not possible even to establish with complete confidence that the companies as described in the database are in fact independent).

Issue: COMP 9 – Specific comparability issues when applying transactional profit methods

It is our view that, in the vast majority cases, the only OECD methods that can be applied are the TNM and transactional profit split methods. This applies to price setting as well as to documentation exercises focusing on the evaluation of the results of applying a policy.

At present, the guidance on the application of methods departs considerably from what we understand to be general practice. Moreover, tax authority practice varies widely with some tax authorities even maintaining that the TNM method is not acceptable despite overwhelming experience of the impracticality of applying the R- and C+ methods.

The extent of that evidence suggests that TNMM should not be treated as a method of last resort.

It would also be helpful to have more guidance on the practical application of these methods, including the level of effort that taxpayers are expected to apply in particular in terms of documentation.

As regards the profit split method it would be helpful from a practical perspective if the Guidelines provided more guidance in terms of conducting a value chain analysis. It has turned out in practice that since more and more MNEs have run through business reengineering exercises in the recent past, traditional functional analysis approaches are not applicable anymore or only restrictively applicable. Therefore, other approaches, i.e. more business process oriented approaches should be allowed and described in the Guidelines.