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

This is a significant issue given that by nature a controlled transaction often exists to the exclusion of other transactions with uncontrolled parties. In practice, taxpayers are required to attempt to apply the arm's length standard using third-party company data in circumstances where no internal comparable transactions exist.

Since it is difficult to acquire third party comparable information at the transactional level in the absence of internal third party transactions, company level information is frequently used in practice. However, this does not necessarily mean that the transactional methods are not applied where the taxpayer is able to find third party comparable companies that are only involved in the type of transaction that is under review.

Para 1.42 of the Guidelines recognises that certain transactions may be aggregated, but only where they are "so closely linked or continuous that they cannot be evaluated adequately on a separate basis". This is slightly more restrictive than the IRS Regulations, which provide that transactions may be aggregated if they are "so interrelated that consideration of multiple transactions is the most reliable means of determining the arm's length consideration"¹. The level of information disclosed in the US is more detailed than is generally the case elsewhere, which may allow for a better evaluation of whether a third party's overall aggregated functions are suitably comparable to those of the taxpayer, and also allows for a review of the third party's activities on a segmented basis.

Despite the fact that the information available on the European databases of company information is less detailed regarding the activities of the companies, there is frequently no alternative source for publicly available company data, as indicated above. It would therefore be useful for the OECD to slightly widen the scope of para 1.42 to provide guidance principles in the use of third party company data to meet the arm's length standard to the greatest extent possible. Some guiding principles to consider may be:

- the principal line of the third party's business should be comparable to the taxpayer's business as it relates to the controlled transaction, on the basis that the third party does not carry on any other significant activities
- product/end market conditions (such as wholesale/retail markets) faced by the comparable line of business should be similar to those faced by the taxpayer in relation to the controlled transaction
- factor/input market conditions (such as the economic conditions in the particular jurisdiction/market) faced by the comparable line of business should be similar to those faced by the taxpayer in relation to the controlled transaction

¹ §1.482-1(f)(2)(i)

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

Third party enterprises that are members of MNE groups should not be systematically rejected, but require careful review before inclusion as a suitable comparable. It is not necessarily true that members of an MNE engage in controlled transactions, although it is probable in most cases. Even where companies that are part of an MNE do engage in controlled transactions, it may be the case that the value of the transactions and/or distortions in pricing of those transactions are not sufficiently significant to cause a systematic rejection of such companies from a potential comparable set, or it may be the case that the transactions take place on arm's length terms (although this can be difficult to verify). Whether or not the value of related party transactions and any resultant distortion in pricing is significant in the particular facts and circumstances of a case is a question of judgement, and it would be difficult to prescribe levels of materiality in the Guidelines. In the absence of sufficient information to evaluate these factors, a member of a MNE group should be rejected.

Where a group's financial statements are consolidated and all entities in the group undertake sufficiently comparable transactions to those under review, any intra-group transactions should have no effect on the consolidated profitability of the group and the consolidated results of the parent company of such a group could potentially be considered as a suitable third party comparable company. However, based on a transactional approach, it is likely that members of MNE groups will engage in a range of transactions, and in practice enterprises within such groups are likely to be rejected on that basis.

An additional consideration is the fact that rejection of third party enterprises that are members of multinational groups frequently results in a set of comparable companies that are significantly smaller than the taxpayer. It may also be difficult to verify the comparability of the operating margins (or mark-ups on the operating costs) of such companies because, for instance, smaller companies may be controlled by their shareholders whose remuneration may be taken in the form of salaries or dividends.

Transactions between members of MNEs may provide useful information, for example in evaluating the profitability of the taxpayer's competitors where a trend in the particular industry can be identified, although such transactions should not be used in isolation from additional independent comparable third party information in view of the likelihood that the pricing may be affected by intra-group transactions.

In our view, the existing guidance need not be amended, since paragraph 1.70 provides sufficient scope for transactions between multinational enterprises to be considered in "understanding the transaction or as a pointer to further investigation". This guidance could be extended to include a reference to the usual comparability tests.

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

Details of the functions and risks, contractual terms and business strategies of third parties may not be available from public third party information. In practice, taxpayers attempt to assess comparability based on the five factors noted in the Guidelines to the extent possible given the information available. This usually involves an analysis of the characteristics of the property and services, functions and risks and economic circumstances of independent companies available on third party databases. In the case of information available on the European databases, there may be very limited details available on the property/services and functions/risks of the third parties, and information on business strategies and contractual terms will not generally be available.

To the extent possible, additional information will be sought from filed statutory accounts and websites of the companies identified in an initial search. In addition, certain screens may be applied in the search for comparable companies, such as a comparison of inventory to turnover ratios to take into account the levels of inventory risk borne.

Frequently, taxpayers rely on the use of an arm's length range which seeks to minimise the effect of comparable information that may be imperfect in terms of all five comparability factors. In the absence of detailed information, it is not desirable to exclude certain companies which may merely have disclosed less information than others (refer to point 4 below). However, tax authorities may sometimes seek to rely on particular comparable third parties which appear prima facie to be more directly comparable to the taxpayer.

Para 1.45 of the Guidelines allows for the use of a range as being "particularly appropriate where, as a last resort, the transactional net margin method is applied", and para 3.38 states that while the use of the range may mitigate the levels of inaccuracy in identifying comparability, it may not account for unique factors affecting the taxpayer.

It may be useful for the Guidelines to provide additional guidance, including a more detailed definition of the arm's length range, as is contained in the IRS Regulations at para 1.482-1(e)(2).² For example, the Guidelines could allow for the use of an adjusted range such as the inter-quartile range where it is difficult to identify the point within the arm's length range that "best reflects the facts and circumstances of the controlled transaction"³ in view of the lack of information on the facts and circumstances of the third party transactions. It would also be useful for the Guidelines to provide guidance on the use of appropriate financial ratios to exclude certain third party companies.

² Refer also to Comp 8 below

³ Para 1.48

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

It is essential to avoid too strict a comparability standard (which may eliminate good comparable companies). Experience shows that it is frequently not possible to obtain perfectly comparable information, and it is therefore necessary to use broad search criteria when identifying third party comparables. Similarly, "cherry-picking" can distort the results of a range of third party comparable companies. "Cherry-picking" by both taxpayers and tax authorities should be explicitly discouraged.

In practice, a well-documented search procedure and comparability assessment criteria make the comparability standard transparent, in that the comparability standard that was applied is clearly stated and its scope can be evaluated. In addition, the results are then less susceptible to "cherry-picking" since reasons for the rejection of each potential comparable are provided. Under a self-assessment system, this transparency allows tax authorities to verify the appropriateness of the selection criteria should they review the transfer pricing policy.

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

Taxpayers must use the data available at the time transfer prices are set for a fiscal year. Where the comparable uncontrolled price method cannot be applied, there is usually no public information available and previous years are therefore considered. The Guidelines recognise that data from previous years can be used to obtain a complete understanding of the facts and circumstances of a transaction, where a transactional profit method is applied (para 1.49). It may be noted by way of comparison that the IRS Regulations provide that multiple year data may be considered depending on the extent of "complete and accurate" information available for the tax year under review, the effect of business cycles, the effect of product life cycles, and where the comparable profits method is applied⁴.

In practice, multiple year data for comparable companies is frequently used when the CUP method is not applied, as it can be helpful in setting a transfer price for the coming fiscal year. Often it is the only information available, though taxpayers and tax authorities should take into account the prevailing and past industry conditions when determining the length of the averaging period, and any changes in accounting procedures that may cause a shift in mean profitability over time. The use of multiple years (rather than one prior year) in setting the transfer price helps to smooth out the effect of the product/business cycle and may provide a more robust range of arm's length prices.

Quite often, the assumptions underlying the determination of the transfer price and the comparable results are reviewed at the end of a fiscal year. Retroactive adjustments may be considered if the taxpayer employs the same set of comparability criteria at the end of a fiscal year as was applied at the outset, and documents the underlying logic of the adjustment so that tax authorities may verify the reasonableness of this adjustment. It should be noted that tax authorities should not use the benefit of hindsight when reviewing transfer prices in subsequent years (para 1.51)

It may be useful for the Guidelines to provide some guidance as to the number of years that should be considered in reviewing multiple year data. For example, the USA and Australia provide such guidance.

⁴ 1.482-1(f)(2)(iii)

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

It is generally agreed that publicly available databases can be used to meet the arm's length standard. There is some variance in the extent to which the standard is met vis-à-vis the Guidelines, because of differences in the level of information available on the different databases, but the taxpayer and tax authority should seek to meet the arm's length standard to the greatest extent.

It is very important when using external data to be able to obtain sufficiently detailed financial data and verify whether the accounting treatment of certain items reported by the comparable companies is the same as the treatment used in the accounts of the taxpayer. In the UK there are industry standards that are generally applied and accounting practices across Europe are generally converging with the move towards international financial standards. However, there is no information available on databases for some countries in Europe, and in many jurisdictions there is no reliable data on gross profit information because of the basis for accounting disclosure. In the US, there are some commercial databases which contain non-audited financial data or which lack detailed financial information. These databases should be avoided.

Alternative sources of information for specific types of transaction are often available to taxpayers, and can often be used (subject to comparability factors) in place of a commercial database. For example, there are sources of information on royalty rates, commission rates, fund management charges, debt factoring charges, interest rates and guarantee fees that can be useful in finding third party comparables.

Taxpayers resident in jurisdictions with limited or poor public financial data who do not have access to transactional methods due to data constraints should seek to compare the profitability of their operations to the profitability of firms in other countries subject to (to the greatest extent possible) similar factor and product markets.

It may be useful for the Guidelines to provide guidance to the effect that tax authorities should take into account third party information from other jurisdictions where there are no local sources of public information available. For example, the South African Revenue Service has stated in its guidance (Practice Note 7, 1999) that because there is limited information available on South African companies, it will accept third party information from other jurisdictions although taxpayers would need to exercise caution and ensure that appropriate adjustments are made to reflect differences between the South African and foreign markets. Some of the factors that the South African Revenue Service indicates would need to be considered are:

- Consumer preferences that may result in different retail prices for a product in the two countries.
- Higher transport costs may be associated with one of the markets. The relative gross margins may be affected by who bears this cost.
- The relative competitiveness of the distribution industries in South Africa and the other countries may differ. This could result in lower gross margins being paid in the more competitive market.
- There may be differences in accounting standards that, if not adjusted for, could distort the relative margins of the parties being compared.⁵

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

Adjustments are frequently applied where companies follow the US approach, even where the adjustments may not in fact increase the reliability of the financial data since the adjustments themselves may be based on estimated numbers (eg where data is segmented or forecasted).

⁵ Para 10.2 SARS Practice Note 7

In our view, it is preferable for the Guidelines to continue not to provide prescriptive guidance on adjustments that must be made, since such adjustments may not always increase the reliability of the comparable information. It is preferable for the taxpayer to be able to use their judgement in determining whether adjustments are required in the particular circumstances.

Issue: COMP 8 – Interpretation and use of data collected

The answer to these questions depends on the quality of the comparables selected based on the information available.

When all the companies selected have a high level of comparability, using the full range may be more appropriate. Generally, the lower the quality of the comparable set, the more likely some truncation of the distribution of results might be to improve the reliability of the result in practice. Taxpayers should note which comparables' results fall within the truncated range and double-check the adherence of those companies to qualitative factors of comparability. The use of the inter-quartile range also depends on the size of the comparable data set, since it is a statistical device that is not necessarily meaningful in a very small set of comparable companies⁶.

Companies should not be rejected because of their financial performance, but because of characteristics that are sufficiently unlike those of the taxpayer in respect of the controlled transaction. Loss-making comparables should not be systematically excluded from the set of comparable companies, since losses are part of the risk of doing business and excluding such companies may distort the arm's length range. In principle, there would be no reason to exclude loss-making companies, but to retain very profitable companies. However, it may be necessary to more carefully review the activities of such companies to ensure that they are comparable in terms of their business strategy and stage in their company or product life cycle. If a company is consistently loss-making over a period of several years, it may be appropriate to exclude it, although cognisance must be taken of the length of the product life cycle in each industry.

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

These problems exist in practice, and in many cases net margin analyses are a good solution. These tend to ensure that like is compared with like for the purpose of the economic analysis. If there are doubts as to the items included on a line by line basis in the company accounts (as is often the case when using third party databases) the use of this method will ensure the comparability of figures used for the calculation of the profit level indicators. The transactional net margin method is frequently used in practice because of difficulties in obtaining suitable third party information on gross margins (as has been noted above).

Although residual profit splits are indeed a very sensible and practical way of determining arm's length pricing for certain types of transactions, this does not mean that a profit split method can be applied merely because of a lack of external comparable data, as a profit split is usually only appropriate for certain types of transaction. For example, the residual profit split is a good corroborative method for the CUP approach when testing royalty rates.

The accuracy of the profit split method depends on the selection of the factors to be taken into account and the weighting given to each factor in determining the profit split percentages. Although this depends on the facts and circumstances of the particular transaction, it may be useful for the Guidelines to provide more detail on the factors to consider in determining a suitable profit split.

⁶ Refer also to Comp 3 above