



**Comments on proposed revision of Chapters I – III of the
OECD Transfer Pricing Guidelines**

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1. Introduction and summary of key points

Ernst & Young has been following closely Working Party 6's Comparability and Transactional Profits Methods projects. Now that these have reached the point at which specific proposals for changes to Chapters I – III of the OECD's Transfer Pricing Guidelines have been tabled, we are grateful for the opportunity to comment again.

In the remainder of this section, we highlight our principal comments. The remaining sections of this response then present our full comments on the drafts.

1.1 Summary of key points

- ▶ Both this limited re-draft of the Transfer Pricing Guidelines (“TPG”) and the OECD's recent business restructuring discussion draft¹ (‘BR discussion draft’) recognize that the transactions within a multinational group can be ‘arm's length’ even if it is not possible to point to comparable transactions or terms between independents. It would be helpful if the limitations of the comparability paradigm were more consistently recognized in the draft, e.g., in paragraph 1.6.
- ▶ The draft can be read as reducing the circumstances in which the transactional profit split method may be regarded as the most appropriate as it removes the reference in the existing TPG to “interrelated transactions”. It is difficult to believe this is intended and some redrafting is required to confirm this.
- ▶ In general, the draft is clear that a weakness in the comparability information cannot be a reason to consider the adoption of the transactional profit split method when the functional analysis supports the adoption of a one-sided method. We recommend that the limited remaining ambiguity on this point be removed.
- ▶ In implementing the transactional profit split method, allocation keys based on internal or external objective data should be used whenever possible. However, it is not always possible to identify objective criteria that approximate how unrelated parties could be expected to agree to share profits when both parties contribute unique intangibles or operate on a highly integrated basis. When this is the case, we recommend that the TPG should allow the application of a contribution analysis based on a subjective allocation percentages which are consistent with the functional analysis, such as a contribution analysis. The draft is unclear on this point and appears, more generally, to be weighted in favor of a residual approach.

¹ “Transfer pricing aspects of business restructurings: discussion draft for public comment 19 September 2008 to 19 February 2009”, OECD, September 2008

2. Chapter 1: the arm's length principle

We comment below on two issues arising from the draft revised guidance in this chapter.

2.1 Limits of the comparability paradigm

Both the addition to TPG paragraph 1.11 and paragraph 27 of the BR discussion draft recognize that the fact that a transaction may not be found between independent parties does not itself mean that the amount of profit or loss associated with such transaction cannot be determined under the arm's length standard.

In view of this (welcome) addition to guidance, it is surprising that the comparability paradigm continues to receive unqualified endorsement in other paragraphs. For example, the extension of paragraph 1.6, which is intended further to elaborate the statement of the arm's length principle in Article 9, is firmly, and apparently exclusively, grounded in the comparability paradigm. This is despite the fact that the business restructuring discussion draft clearly puts forward an alternative paradigm for evaluating, in the case in point, whether a contractual allocation of risks is to be regarded as consistent with the arm's length standard.

It is probably too late at this stage to attempt a more general framework for assessing the arm's length nature of "conditions". However, it should be possible to recognize that comparability should not be regarded as the only paradigm.

2.2 Contractual terms – choice of example

The example at the end of paragraph 1.53 does not clearly illustrate the point. The contractual terms upon which accounting services are provided clearly define the level of assurance offered in recognition of the considerable liabilities potentially arising for the service provider from any misunderstanding. It is unlikely that a related party provider of similar services would be exposed to the same risks; and it is to be expected that the impact on pricing would be considerable. This is one reason why the CUP method cannot generally be reliably applied to accounting or other internal services.

3. Chapter 2: transfer pricing methods

In our response to the Transactional Profits Methods discussion draft issued in February 2008 (“TPM discussion draft”), we have welcomed the refinement of the “method hierarchy” to focus on “finding the most appropriate method for a particular case” (as paragraph 2.1 puts it).

However, the draft revised guidance in this chapter also includes some other important, although more detailed, changes, some of which we comment on below. In particular, we have noted some significant amendments to guidance on the profit split method including, arguably, changes from the proposals in the TPM discussion draft.

3.1 Circumstances in which the transactional profit split method can be reliably applied

There is only a brief discussion in paragraph 2.63 of the draft of the circumstances in which the application of the transactional profit split method should be considered:

- ▶ For highly integrated businesses where the use of a one-sided method would not be appropriate
- ▶ When both parties contribute unique and valuable assets

No reference is made to a further set of circumstances in which the existing TPG envisage the application of the profit split method:

“Where transactions are very interrelated it might be that they cannot be evaluated on a separate basis. Under similar circumstances, independent enterprises might decide to set up a form of partnership and agree to a form of profit split.”²

In our view, this is an important, and potentially unhelpful, change. A rationale for applying a profit split method because transactions are interrelated is clearly distinct from a rationale based on the highly integrated nature of a business. In the former case, the separate transactions cannot be reliably priced; in the latter case, the contributions of the parties to what may be a single transaction cannot be reliably valued using conventional methods.

It may be that the change is more apparent than real if the consideration of when the transactional profit split method can be reliably applied is read in conjunction with the discussion in paragraphs 3.9 – 3.11 of the draft on the circumstances in which transactions must be viewed together in order to make a reliable analysis. That is, in a first step it would be determined that transactions need to be viewed together; and, in a second step, that both parties are contributing unique and valuable assets.

If this is the case, it would be helpful to include a suitable cross reference in paragraph 2.63.

In addition towards the end of paragraph 2.63 it is stated that “a *transactional profit split method would **ordinarily** not be used in cases where one party to the transaction performs only simple functions and does not make any significant unique contribution...*” (emboldening added)

Given that paragraph 3.38 makes it clear that a deficiency in the comparables data is not a reason to reject a method (e.g., apply a profit split rather than the TNMM), it is unclear why the qualification is needed. We suggest that either ‘ordinarily’ be deleted or the additional

² TPG at paragraph 3.5

circumstances in which the transactional profit split method may be capable of being reliably applied be articulated.

3.2 Role of contribution analysis

Our reading of the current TPG is that contribution and residual analyses are to be seen as alternative, but not mutually exclusive or exhaustive, approaches to profit split. This was the view taken in the TPM discussion draft at paragraph 205. Indeed, it was stated there that:

“The allocation of a residual profit may be seen as a contribution analysis relating to the residual profit, even where the entirety of the residual profit is allocated to one party.”³

Our experience is that residual analysis is often inadequate for dealing with highly integrated businesses with multiple non-routine contributions which cannot be reduced to common measures other than at the risk over-simplification. Where necessary to make a reliable analysis, we have undertaken a contribution analysis based on management’s assessment of the value of contributions.

We have therefore attached considerable importance to the existing paragraph 3.18 (2.74 in the draft with the addition referred to below):

“It can be difficult to determine the relative value of the contribution that each of the related participants makes to the controlled transactions, and the approach will often depend on the facts and circumstances of each case. The determination might be made by comparing the nature and degree of each party’s contribution of differing types (for example the provision of services, development expenses incurred, capital invested) and assigning a percentage based upon the relative comparison and external market data.”

The present draft still distinguishes contribution and residual analysis. But in discussing each, there is a reference forward to lengthy guidance on splitting profit at paragraphs 2.86 – 2.99.

In paragraph 2.86 it is stated that the criteria or allocation keys should ‘be supported by reasonably reliable comparables data, internal data, or both’. Thereafter the focus is on measurable allocation keys or market data except that paragraph 2.98 states:

“Internal data are essential to assess the values of the respective contributions of the parties to the controlled transaction. The determination of such values should rely on a functional analysis that takes into account all the economically significant functions, assets and risks contributed by the parties to the controlled transaction, including an evaluation of the relative importance of those functions, assets and risks to the value added to the controlled transaction. Particular attention should be given to the identification of the relevant contributions to the significant intangibles and significant risks and the importance, relevance and measurement of the factors which gave rise to these significant intangibles and risks.”

Despite careful study, we are unclear what the status is in the new draft of an approach based on (in the absence of reliable objective allocation keys) the assignment of percentages following an in-depth functional analysis.

In our view, the TPG should clearly permit the adoption of structured techniques resulting in allocation keys based on management insight into the relative value of contributions when market or other objective data is insufficient.

In our response to the TPM discussion draft we recommended that the TPG should be amended to provide additional guidance on contribution analysis.

³ TPM discussion draft paragraph 208

As it is, our impression after reviewing the draft is that, if anything, the balance has been shifted strongly towards residual analysis using “objective” allocation keys, preferably reliant on external data. Indeed, it would appear that, whereas previously contribution and residual analyses were, as noted above, alternatives, the present draft can be seen as creating a hierarchy within which a contribution analysis is a last resort.

We recognize that the use of objective allocation keys is to be preferred. However, this should not be at the expense of reliability.

To provide a simple example, it has been established that marketing is a key value adding function. It has also been noted that marketing takes place at global, regional and local levels. Moreover, it has been determined that the framing of the global strategy; its translation into a regional strategy, and effective local implementation are all non-routine contributions. Some mechanism is required for determining an allocation key which is reflective of the value of the contribution at each of these levels. The funding of marketing expenditure must also be taken into account.

It is our view that, in examples like this, an assignment of percentages based on an in-depth functional analysis is more likely to yield a reliable result rather than, for example, one based on the fully-loaded salary costs of marketing employees. This is because, as the TPG fully recognizes in relation to intangibles, cost can be an unreliable proxy for value.

For the avoidance of doubt, this is not to say that, for example, capitalized costs may not be a reliable allocation key in some circumstances. Rather, our point is that the reliability of the allocation key is a vital step in the analysis and there can be no presumption that a reliable objective allocation key will be available.

3.3 Determination of the net profit (stock options)

In the OECD's view, when calculating net profit for the application of the transactional net margin method, only those items that directly or indirectly relate to the controlled transaction at hand should be included. Non-recurring items in general, direct tax and interest income and expense other than on trade receivables and payable should be excluded. On the other hand, the profit margin should include interest income, or working capital adjustment should be considered if financial terms affect prices. Analysis of foreign exchange of a trading nature should also be performed.

Other areas to consider when determining net profit margin include amortization, depreciation, stock options and pension costs. In the OECD's view the decision of whether to include such items in the determination of the net profit margin for applying the transactional net margin method will depend on a consideration of their expected effects on the appropriateness of the net margin indicator to the circumstances of the transaction and on the reliability of the comparison, as well as on whether more reliable indicators are available.

Ernst and Young agrees that some analysis should be made of the financial data of the tested party and comparables in order to ensure comparability. This is, however, often difficult due to lack of appropriate information. This may be particularly true for remuneration cost adjustments. Additionally, extensive analysis may be costly and not reliable. Ernst & Young believes that the effort to adjust the net margin should only be undertaken if it is likely to yield a more reliable result. This is not specified in the current draft.

Furthermore, the current draft is not clear whether stock options and similar economic costs would be considered operating expenses and as such included in the determination of the net profit to the extent that they are rejected as result of valuation issues. A clarification on this point would be helpful. Remuneration which is intended to serve as a form of compensation may need to be included depending on the facts and circumstances. In other cases, such grants may not be primarily for the performance of services and thus should be excluded.

3.4 Comparability standards and TNMM

We largely agree with the general discussion of the TNMM at 2.100 – 2.117, including the importance of undertaking a comparability analysis. However, as is well recognized (including in 2.110), there is often only limited information available.

However, the example at 2.114 - 2.115 suggests that there remains a significant gap between the mindset underlying this draft and the practical realities of transfer pricing analysis.

Any transfer pricing analyst would acknowledge the theoretical relevance of points made in these paragraphs. However, making any quantitative adjustment to imperfect comparables to reflect undoubtedly important product and market differences is unlikely to be possible. At best, scrutiny of the available comparables might identify a 'more comparable' sub-set. Very often, the analyst will either have to make a judgmental adjustment or review the comparability criteria in the hope that by, for example, compromising on product comparability a better indication of the profitability of resellers in buoyant segments of consumer electronics can be obtained.

4. Chapter 3: comparability analysis

4.1 Databases

Ernst & Young agrees that the use of commercial and proprietary databases is a practical and cost effective way of identifying external comparables; and that they should only be used if and to the extent that internal comparables are not available. We also agree that database searches should not be used in isolation but rather should be refined with other publicly available information in order to improve the quality of the comparability analysis.

Although there is no reference to which other public information should be used to supplement the database searches, it would be helpful to have a reference to the use of the Internet as source of information. In fact, it is our experience that this source has much improved the availability of information. However, issues of reproducibility for the use of the Internet should be considered and prevented through the retention of appropriate documentation. It must be acknowledged that the risk of “cherry picking” will remain and therefore, it is necessary to balance this risk against the value of the source of information when the alternatives available are often poor and almost invariably very costly.

4.2 Use of non-domestic comparables

The draft recognizes that searches on a country-by-country basis are not always performed and that non-domestic comparables should not automatically be rejected. We welcome the statement that a determination of whether non-domestic comparables are reasonably reliable should be made on a case-by-case basis and by reference to the five comparability factors. Paragraphs 1.56 and 1.57 provide useful additional guidance on the circumstances in which regional comparables may reliably be used.

4.3 Information undisclosed to taxpayers

The draft recognizes that tax administration may have access to information that may not be disclosed to the taxpayer. We agree with the OECD’s view that the use of such information should be allowed only to the extent that tax administration is able to disclose such data to the taxpayers in advance, allowing the latter to defend their positions. This is necessary to balance the interests of tax administrations and taxpayers.

4.4 Selecting or rejecting potential comparables

The draft describes two acceptable approaches to identifying comparables: the “additive approach” where potential comparables are added to the analysis based upon industry knowledge and the “deductive approach” where comparables are eliminated from a population of potential comparables using selection criteria and publicly available information (e.g., databases, Internet sites, information on known competitors of the taxpayer).

In the OECD’s view, one of the advantages of the “deductive” approach is that it is more reproducible and transparent than the “additive” approach.

We agree with the points made about the importance of using qualitative data in the screening process and welcome the explicit reference to the use of the Internet in the deductive approach as a way to refine the list of potential comparables. As mentioned earlier, this is an invaluable source of complementary qualitative information, but it can also be used to identify potential additional comparables.

We also agree that documentation should ensure the transparency of the search process, so that it can be reproduced. However, in our view, reproducibility cannot be treated as an absolute requirement. Most particularly, the Internet is a “live” tool, which makes it impossible to provide assurance that a search is reproducible. In our view this should not be a barrier to its use. However, it is important that the taxpayer should document the Internet search and retain copies of information derived from the internet search in evaluating potential

comparables. The risk of “cherry picking” is more than offset by the value of information from this source.

In addition, it is also important to recognize the risk that revenue authorities may seek to focus on particular data as well. Such risk could be mitigated by requiring both taxpayers and tax administrations to provide similar levels of detailed information in their comparability analyses. If a tax administration chooses to challenge a taxpayer's comparability analysis through the preparation of an alternative comparability analysis, that alternative analysis should be at least as detailed as the taxpayer's original analysis so that the taxpayer can respond.

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