

Contact Information:

John Hollas
Managing Director
Ceteris
Calgary, Alberta
Canada
Email: john.hollas@ceterisgroup.com
Phone: 403-444-5694

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Introduction

The OECD has invited comments on the series of Draft Issues Notes arising from Working Party No. 6 ("WP6") review of comments received from the public on comparability when applying the OECD authorized transfer pricing methods.

The following sections include the author's comments to each of the Draft Issues Notes on comparability and should be read in the context of the full text of the OECD Draft Issues Notes (please refer to "*Comparability: Public Invitation to Comment on a Series of Draft Issues Notes*" 10May2006, OECD).

This review focuses on the following components in the OECD Draft Issues Notes on comparability:

1. Putting a comparability analysis and search for comparables into perspective;
2. Timing issues in comparability;
3. Internal comparables;
4. Determination of available sources of information and of their reliability;
5. Uncontrolled transactions;
6. Examining the five comparability factors;

7. Selecting or rejecting third parties or third party transactions etc;
8. Determination of and making comparability adjustments where appropriate;
9. Multiple year data;
10. Aggregation of transactions;
11. Definition of the arm's length range; and
12. Documenting a search for comparables.

1. Putting a comparability analysis and search for comparables into perspective

- A. *A review of Article 9*
- B. *Linking the search for comparables and comparability analysis*
- C. *Taking account of the burden and costs involved in comparability analyses*

Comments

The arm's length principle is applied by comparing controlled transactions with transactions between independent enterprises based on "economically relevant characteristics." In other words, it is only through a comparability analysis that a taxpayer (or tax administrator) can meet (test) the arm's length standard for a specific transaction.

Comparability is achieved in those situations where there are no differences between the controlled and uncontrolled transactions; or the differences that do exist do not materially affect the price or profit of the transaction being examined; or if "reasonably accurate" quantitative adjustments are made to eliminate the effect of any, and all, material (i.e., economically significant) differences.

WP6 has provided an example of how to find external comparables in the section, "*Selecting or rejecting third parties or third party transactions – Part A: Description of a typical process of identifying comparable transactions...*" The author agrees with WP6 that the OECD should provide further guidance on Steps 7 and 8 of the typical search process as the comparability analysis is both the most critical part of the process and the greatest challenge faced by taxpayers (and tax administrators) in determining (assessing) the transfer price or allocation of profit.

The WP6's final point is in regard to the assessment of the cost-benefit analysis that a taxpayer would perform to determine whether or not to undertake a search for external comparables. This determination should always be a matter of the taxpayer exercising prudent business judgment. As

indicated by WP6, the rationale for this decision should be documented by the taxpayer, including the process and outcome of its internal cost-benefit analysis.

2. Timing issues in comparability

- A. *Existing guidance*
- B. *Timing of collection of information by the taxpayer*
- C. *“Ex Post Facto” review of transfer prices: Use of information on comparability factors and comparable uncontrolled transactions that is obtained at a significantly later date (e.g., during an examination which takes place two or three years after the transaction)*
- D. *Timing and origin of CUT*
- E. *Other issues*

Comments

In the author’s view, the timing issues in comparability are a matter of the divergent perspectives of taxpayers and tax administrators. These two perspectives are: 1) setting or determining the transfer price on a current or prospective basis, and 2) testing the transfer price after the transaction is completed or under examination. In setting the transfer price the taxpayer would need to rely upon information that is available at that time. In practical terms, the taxpayer, if applying a profit based method, is relying upon financial information on external comparables that is historical and not matched to the period under review. Timing and access to timely information issues do exist in arm’s length pricing, in most markets.

If, in an arm’s length arrangement, the parties receive additional information at a later date that would have changed the price or allocation of profit if known at the time the transaction was entered into, it is not, in the absence of an ability to renegotiate the transaction, expected that the original price would be adjusted.

The author’s view is that tax administrators should consider only the information that was available at the time the taxpayer set its transfer prices and not to test the results on an *ex post facto* basis.

3. Internal comparables

- A. *Definition – Existing guidance*
- B. *Practical experience*
- C. *General preference for internal comparables over external comparables: rationale and limits*
- D. *Possible developments*
 - a. *Internal comparables and transfer pricing methods*
 - b. *Internals comparables and particular transactions*
 - c. *Documentation issue*
 - d. *Transactions between other parts of the MNE group and unrelated parties*
- E. *Preliminary conclusions*

Comments

In general, the author agrees with most of the conclusions or recommendations arising from the draft issues notes on internal comparables. The author would, however, like to reinforce the need for clarification in the OECD Guidelines as to the explicit meaning of internal comparables (and by extension external comparables). In particular, the reference to the comparable uncontrolled transactions between another member of the group (i.e., not the taxpayer) and an unrelated party needs to be considered in the definition of internal comparables.

The author is somewhat concerned with the overt emphasis or preference for internal comparables over external comparables. As comparability is the arm's length principle, tax administrators need to allow the taxpayer to search for, and select, those comparables (whether or not they are internal or external) that are the best fit to the conditions in which the transaction occurs. While internal comparables may appear to be superior in terms of the taxpayer's access to more reliable information with respect to the Five Comparability Factors (5CF), it is for this very fact (availability of reliable data) that, in practice, the comparability analysis leads to the internal comparables being rejected due to unquantifiable differences in the economic conditions or business strategies that are economically significant and relevant to the transaction.

As it is widely recognized that MNEs are complex organizations with integrated global businesses that create a myriad of operations and transactions, the taxpayer's ability to identify and monitor all of these business relationships that could produce potential internal comparables is a daunting task at best and most likely an impossible one (from a practical business perspective) at worst.

The author agrees with the WP6 that there needs to be further clarification on the use of internal comparables in all of the approved methods, not just the traditional transaction methods. The author notes that the absence of any comments on the profit split method is perhaps an oversight. There are, within the many types of business relationships - from strategic alliances to formal joint ventures – potential sources of internal comparables for determining the arm’s length split of the residual profit under the residual profit split approach.

4. Determination of available sources of information and of their reliability

- A. Informal and confidential information*
- B. Databases*
- C. Public information*
- D. Foreign source or non-domestic comparables*

Comments

It is well known that the selection of the appropriate transfer pricing method rests, to some extent, on the availability and reliability of relevant information or data. In addition, the source and use of the information should embrace the concepts of; 1) transparency, and 2) auditability. Notwithstanding, there is no question to the statement that there are significant difficulties in obtaining reliable information or data to apply the arm’s length principle.

With respect to the use of confidential information, the author agrees with the Issues Notes in that confidential sources of information can not be used to determine or to assess the transfer price. The use of “secret comparables” should be strongly discouraged in the context of a tax administrator assessing an adjustment to a taxpayer’s transfer pricing. Similarly, the taxpayer should not use confidential or unsupportable information in determining its transfer prices. In both cases, there is a lack of symmetry with respect to access to information and as such the process by which the transfer price is set (or adjusted) would not be reproducible by the other party if confidential information is used.

The position taken by WP6 on the issue of using secret comparables in MAP cases needs to be clearly stated, if used at all, as an exception that must have a very well defined set of circumstances and boundaries. Under no circumstances, as stated above, should secret comparables be used to determine the assessing position of the tax administrator. The ability of tax authorities, under the bilateral tax

treaties, to exchange all sorts of confidential information (including secret comparables) should be limited to the competent authority process and to only those negotiations in which the purpose is to seek relief for the taxpayer from double (or multiple) taxation.

With respect to the use of proprietary third party databases, particularly pertaining to third party agreements that are developed by consulting or advisory firms, the author notes WP6's position that this data should not be used as it is not reproducible (in some other manner) by the tax authority. The author's view is that this position is not valid or acceptable. The taxpayer should, in all cases, be permitted to consider third party proprietary databases that arm's length parties, in an uncontrolled transaction, would access in order to determine their pricing. As an example, it is not uncommon for arm's length lenders or financial institutions to rely upon third party proprietary databases, e.g., Bloomberg databases or Loan Pricing Corp's DealScan, to assist them in pricing all types of financial instruments or transactions. Since this source of data is available to, and used by, third parties in arm's length transactions it should be permitted in controlled transactions.

The WP6's position on the use of large commercial databases is important, as this source of data is used quite frequently in practice by most transfer pricing practitioners and taxpayers. The distinction between an "additive" and "deductive" approach to the search for (external) comparables is only an issue in the context of ensuring that there is always an element of objectivity in the search for comparables.

5. Uncontrolled transactions

- A. *Description of the issue and existing guidance*
- B. *Extent to which controlled transactions can be used in a transfer pricing analysis*
- C. *Alternative options*
 - a. *Broadening the search*
 - b. *Uncontrolled transactions carried out by MNE groups*
 - c. *Possible use of consolidated data*
 - d. *Influence of minority shareholders*

Comments

As the underlying premise of Article 9 is a comparison of the controlled transaction to uncontrolled transactions, the use of controlled transactions to determine or assess the transfer pricing would be

contrary to the arm's length principle. However, there is no universal conclusion amongst tax authorities on the definition of related party or controlled transactions.

The author agrees that due to the pervasive strategy of MNE towards vertical integration, it is difficult, if not impossible, to find truly independent enterprises. In addition, there are strategic alliances and virtual supply chains that exist even amongst otherwise independent enterprises. As such, there should be more guidance issued by OECD on the circumstances or situations in which a taxpayer could consider using controlled transactions as comparable transactions in its transfer pricing analysis.

The exploration of alternative options is actually a discussion on lessening the comparability standards. In those situations in which data is not available or reliable, the taxpayer should have alternative means by which to determine their transfer prices. In practice, taxpayers would look to broaden the search criteria to include other industries or markets with similar economically relevant characteristics. The OECD should provide additional guidance on when the lessening of the comparability standard would be acceptable.

The author comments on the issue of using consolidated data of comparables under the section entitled “*Aggregation of Transactions*”, below.

6. Examining the five comparability factors

- A. *General comments: evaluating the importance of missing information on the five comparability factors for external comparables*
- B. *Discussion of specific issues in relation to each of the five factors*

Comments

The author agrees with the Draft Issues Notes that, in principle and theory, the five comparability factors (5CF) are critically important in selecting the appropriate comparables and that, in practice, there needs to be some flexibility (on a case-by-case basis) in applying the 5CF in the absence of information on the 5CF.

While the example of the road transportation service provider was illustrative, the OECD should provide more examples or illustrations of how to apply the 5CF in order to assist taxpayers and tax

administrators in making necessary assumptions with respect to the limitations of some of the factors, e.g., business strategies and economic circumstances.

It is widely accepted that the characteristics of the product or services must be at a high degree of comparability when comparing prices and applying the CUP method, but there is a somewhat lesser standard of comparability when comparing margins.

The OECD should provide further guidance on the need to apply this factor when examining profit margins (gross or net). In particular, and with respect to the Resale Price or Resale Minus method, a distributor of furniture or clothing would likely earn a different gross margin (estimated at 50% to 60%) than a distributor of laboratory instruments (estimated at 5% to 15%), as the costs of the various distribution functions for different types of products are not entirely comparable.

The functional analysis, in the context of the comparability analysis, involves a comparison of the functions performed (taking into account the assets being used and the risks assumed) between the controlled transaction and the uncontrolled transaction to identify the economically relevant and significant activities and responsibilities undertaken by the tested party compared to the independent parties. The OECD should provide further guidance on how to perform a functional analysis in a comparability analysis given the lack of information available to the taxpayer on the risk taking functions and intangibles of the comparables.

Comparing the contractual terms, outlined in the contractual arrangement of the controlled transaction, to the external comparable transactions assumes that the uncontrolled transactions are external written agreements that are available to the taxpayer (i.e., filed with SEC, etc.). The OECD should clarify that this factor is relevant only when applying a comparable uncontrolled transaction (CUT) approach to determine the price or margin. The contractual terms contained within the agreements would need to be considered as economically relevant in that arm's length parties would not have included these terms if they did not have some value in outlining how the responsibilities, risk and benefits would be divided between the parties to the transaction.

Economic circumstances are extremely important elements to consider when determining comparability of the transactions, but it is very difficult to provide a standard process of quantifying the impact of differences. Even if the products or services are the same, the arm's length prices (and

profits) may vary across different markets or geographies. In determining if a market is comparable, the analysis should include a comparison of economically relevant factors.

Business strategies can, over a short time frame, impact prices and margins. The OECD should provide guidance on how to account for differences in business strategies. While the easy answer is to apply this comparability factor in a strict manner, this will not achieve a practical solution for taxpayers dealing with this issue. With proper documentation, the taxpayer should be permitted to utilize any business strategy that would be available to arm's length parties. The economic impact (or at least the direction of the impact) of a specific business strategy can be explained by economic theory and should be accepted by tax administrators.

7. Selecting or rejecting third parties or third party transactions etc

- A. Description of a typical search process for identifying comparable transactions and using data so obtained*
- B. Degree of objectivity of the list of comparables: the “additive” and the “deductive” approaches*
- C. Transparency and reproducibility of the process followed to select /reject comparables*

Comments

In the author's view, the description of the typical search process for external comparables is a welcome example but with the overriding caveat that no two searches are ever identical.

The author agrees with the WP6 statement that Step 7, the identification and selection of comparables, is critical to the entire process and that further guidance is required from OECD. As stated above and elsewhere in this reply, it is recognized that a high degree of objectivity is required when selecting the comparables. In addition, the entire search process, to the extent possible, should have complete transparency and be reproducible by the tax authority upon audit or examination. From a practical perspective, the information that was relied upon (especially from the commercial databases) may change over time (e.g., financial statements being restated by corporations) and as such the search may not be fully reproducible at the time of the examination. In these cases, the tax administrators should seek out the same sources of information that the taxpayer relied upon to determine its transfer prices or accept the information as presented by the taxpayer rather than conducting a new search.

In the author’s view, the two approaches, additive and deductive, are not mutually exclusive. In practice, the industry research and analysis would typically identify major players in the same industry or markets as the taxpayer. This “additive” source of potential comparables is objective, transparent and (potentially) reproducible.

8. Determination of and making comparability adjustments where appropriate

- A. *Existing guidance*
- B. *Practical experience in adjusting comparables*
- C. *Acceptability of comparability adjustments*
- D. *Preliminary conclusions*

Comments

The author agrees with the conclusions and recommendations of WP6 with respect to comparability adjustments.

The OECD should provide guidance on the process of determining and making comparability adjustments. As an example, the author has outlined and described the following process that a taxpayer or tax administrator may undertake:

1. From the industry analysis itemize the “economically relevant characteristics” that could potentially have an impact on the price or profit margins;
2. Identify the differences that exist between the controlled transaction and the comparable uncontrolled transactions;
3. Determine which of the identified differences would be “economically relevant characteristics” between the uncontrolled and controlled transactions and as such would need to be adjusted, i.e. comparability differences;
4. Consider whether these comparability differences can be quantified in a reasonable and reliable manner;
5. Calculate and make the adjustment to the comparables; and
6. Prepare documentation of the comparability analysis.

9. Multiple year data

- A. *Existing guidance*
- B. *Comments received from business community*
- C. *A few considerations related to the use of multiple year data*
- D. *Issues which should not be confused with the use of multiple year data*
- E. *Preliminary conclusions*

Comments

While there are a number of issues to consider with respect to the “use of multiple year data”, the main issue, to a great extent and in the author’s opinion, is one of the appropriate definition or application of multiple year data. The author agrees that the use of multiple year data can assist the taxpayer in understanding where, in the business (or product) life cycle, the comparables are relative to the taxpayer. Accordingly, the use of multiple year data is a useful screening and analytical tool.

The other application of the use of multiple year data is as a statistical tool. In general, the use of multiple year data in creating statistical tools, such as multiple year averaging to smooth out the effect of business (or product life) cycles, provides a quantifiable means to make a comparability adjustment for differences in economic circumstances. As stated in the comments on comparability adjustments, the author suggests that tax administrators accept the taxpayer’s adjustments for differences in the business cycle (i.e., economic circumstances), subject to the overriding tests of quantification, reliability and reasonable accuracy.

10. Aggregation of transactions

- A. *Description of issue*
- B. *Business comments received*
- C. *The OECD View*

Comments

The issue of aggregation of transactions, in the context of the Draft Issues Notes, relates only to the comparables and not to the issue of how (or whether) the taxpayer should bundle (or un-bundle) transactions. There is usually a conflict between using company-wide data (or aggregated data) and specific transactional data of the comparables. While it is recognized that all the OECD approved

methods are transactional methods, it is not always possible to obtain transactional data on external comparables. In some markets, and in some cases, taxpayers may be able to obtain segmented financial information on the business units of the comparable being reviewed. This is not transactional data, but can be more reliable in terms of comparability than using company-wide data.

In the absence of any (reliable) transactional data, the taxpayer should be permitted to use company-wide data for those selected comparables that perform similar functions (taking into account the similarity of risks assumed and intangibles employed). The OECD should provide guidance on when the taxpayer would be warranted to use a comparable that had an aggregation of different types of transactions.

11. Definition of the arm's length range

- A. *Definition of the arm's length range*
- B. *Extreme results: comparability considerations*
- C. *Approaches to enhance reliability*
- D. *Loss making comparables*
 - a. *Business comments*
 - b. *Countries comments*

Comments

In the author's view, the concept that all comparables are equally comparable is a difficult one to support. In theory, once a comparability analysis has been performed on the selected comparables, and comparability adjustments have been made, the comparables should be considered equal and the range would be an arm's length range. In practice, the quality of adjustments may differ, due in part to the availability of (or lack of) reliable data, and accordingly, the range is a proxy for the arm's length range.

The use of statistical tools such as the median or the inter-quartile range helps to eliminate, or at least lessen, the impact of extreme results but is not a replacement for the comparability analysis irrespective of the extent and quality of the information available on the comparables. The OECD should consider providing guidance on the use of statistical tools in determining the arm's length range, such as the minimum size of the sample of selected comparables required to use some of the statistical tools.

12. Documenting a search for comparables

- A. *Existing guidance*
- B. *Contributions received from the business community*
- C. *Structure of a TP Study (Comparability Analysis)*
- D. *Preliminary conclusions on documentation issues*

Comments

The OECD should provide further guidance on how a transfer pricing analysis should be conducted and the need for supporting documentation on describing and explaining the search process, including the comparability analysis and the selection/rejection criteria.