

COMMENTS ON DRAFT NOTES ON COMPARABILITY

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

-B (link between search for comparables and comparability analysis):

Our view is that financial indicia have two-fold benefits: objectivity and cost-effectiveness.

We believe that financial indicia can be used as quantitative criteria to make sure that the conditions of a transaction are comparable to those of the tested transaction. The selection of relevant financial indicia and the determination of thresholds beyond which a transaction is considered to be non comparable can include some level of subjectivity. The level of objectivity could however be easily increased through determining the thresholds based on the values taken by the same relevant financial indicia for the tested transaction. Moreover, the objectivity of using accounting data is arguably higher than that of using qualitative criteria.

The selection of relevant financial indicia computed using profit and loss or balance sheet data should be based on the functional analysis and the profile of the tested company.

An example of a financial index that can be used to test comparability is the ratio of inventory to sales or total assets. This ratio would arguably be close to zero for a commissionaire or a sales agent and could therefore be used, together with other financial indicia and information, to discriminate between these kinds of entities on the one hand and other types of distributors on the other hand.

When it is not possible to identify single-activity comparable companies, a financial index threshold should be determined beyond which any additional activity performed would be considered to significantly impact profit, thus leading to the rejection of the company. There are no generally applicable financial indicia and thresholds that should be applied, but, instead, they should be chosen on a case by case basis. Examples of additional activities are installation or maintenance services, sales of second-hand products, sale of spare parts, etc.

Further, using financial indicia often has the advantage of being more cost-effective than searching for qualitative information, given that large quantities of financial data can be easily and quickly found on public databases.

2. Timing issues in comparability

- B-1 (retroactive adjustments):

In respect of year-end adjustments, our view is that the more complex the functions, the higher the risks, and the more valuable the assets, the lesser a year-end adjustment is justified. By definition, an adjustment for a simple function, low risk, and low value asset would be justified by the allocation of a lower remuneration.

Retroactive adjustments of the values of imported goods can have an impact on custom duties and VAT, which are computed on a provisional basis. Any gap between budgeted and actual transfer prices should give rise to a year-end adjustment that can be quarterly, semestrial or annual. The longer

the adjustment period the more difficult the resulting custom and VAT impacts will be difficult to solve.

We would recommend that companies make lists of the events that would trigger year-end adjustments and account for them in their transfer pricing policy as well as in their agreements with affiliated companies, so that they can be opposed to an administration.

In countries where contemporaneous documentation is required, year-end adjustments are necessary when economic and market conditions for the selected comparable companies have changed. If a change has occurred, the relevant question is whether the impact can be measured. An adjustment would be necessary in this context.

The results of a group entity should be assessed in light of the global group performance. An adjustment might be necessary if, for example, the group has been loss-making for some time, and the non entrepreneurial entity is remunerated say at the median level. It might be appropriate to adjust the result of the profitable entity in order to align it with that of the group. For example, its remuneration could be adjusted to the bottom of the arm's length range of results.

To summarize, three factors are critical in respect of year-end adjustments: the profile of the company, whether companies are required to prepare contemporaneous documentation, and the group performance.

- B-2 (documentation prior to the transaction):

We believe that requiring documentation to be established prior to a transaction taking place would be unreasonable; given the risk such an approach would run of impeding the development of international trade. The maximum that could be required of companies would be to document their transactions in a given year at the year end of the same year.

- B-3 (documentation at time of filing of tax return):

In countries where contemporaneous documentation is required, we believe that comparability analyses should be updated annually. In other countries, we believe that comparability analyses should be considered to be valid, as long as at least one of the years within the statute of limitations is covered by the analysis.

- D-2 (data relating to subsequent years):

We agree on the fact that taxpayers should monitor and review their transfer prices to account for changes in the business environment or any other changes.

Our view is that the frequency at which a functional analysis should be reviewed depends on the industry and the country considered. We tend to think that a functional analysis should be reviewed annually. This should be particularly the case for MNEs operating in fast-moving industries. The frequency of the review, however, would depend on the level of contemporaneousness that is required in the country considered. If the legislation requires an annual update of the functional analysis (to account for reorganisations of flows, acquisitions, development of new intangibles, etc.), then the comparability analysis should be updated annually. In some countries where the typical period examined spans over three years, the comparability analysis should be updated as soon as none of the years within the statute of limitations is covered by the comparability analysis. In any case, the comparability analysis should be reviewed as soon as it no longer matches the functional analysis of the company.

- E (other issues):

We agree that it would be worth providing guidance on the impact of transfer pricing adjustments on VAT, customs, and other taxes.

3. Internal comparables

- C (rationale and limits of general preference for internal comparables over external comparables):

We agree that it would be useful to provide a definition of internal and external comparables and detail the general preference for internal comparables over external comparables.

We believe that internal comparables are theoretically preferable over external comparables, but, in our experience, it is rarely the case that a potential internal comparable meets the five comparability criteria, due to often taking place in different geographic markets or under different conditions.

- D-4 (transactions between other parts of an MNE group and unrelated parties):

We do not see any reason why transactions between other parts of an MNE group and unrelated parties could not be considered as internal comparables, if they are subject to the same analysis as transactions between the same part of the MNE group and unrelated parties; in other words, as long as they mostly satisfy the five comparability criteria.

5. Uncontrolled transactions

- B (use extent to which controlled transactions can be used):

We agree that controlled transactions cannot be used as the sole basis for a transfer pricing adjustment.

We however believe that in cases where information on uncontrolled transactions is limited, controlled transactions can be useful to corroborate, supplement, or refine analyses based on uncontrolled transactions. In oligopolistic industries, such as the automobile industry, the only available data often relate to dependent companies only.

This could be the case for example where the analysis relies on a small sample of comparable uncontrolled transactions, whereas a large sample of comparable controlled transaction is available. On statistical grounds, the large same of controlled transactions could be considered as a reliable measure of arm's length transfer pricing based on the likelihood that an overestimated transfer price for a given company would be compensated by an underestimated transfer price for another, therefore arguably resulting in the range of prices being arm's length. This could be the case as long as the sample of controlled transactions was sufficiently large (arguably a minimum of 20 or 30 transactions).

In addition, it is worth noting that, in practice, dependent companies are often more comparable than independent companies based on the five comparability factors. This is another reason why using dependent companies to corroborate a comparability analysis based on independent companies is always useful.

We would welcome the OECD's view on this point, all the more that, in practice, some administrations tend to favour dependent companies over independent companies. The questions are whether dependent companies should be used when information on independent companies is not available, whether other methods based on internal data can be used instead, or whether the search for comparable companies be redirected to a connected industry.

When it can be demonstrated, based on a usual comparability analysis, that all entities of a group are comparable, we consider that the group can be retained in a sample of comparable companies, because the potential distorting effects of non arm's length transfer prices are evened out at the consolidated level.

6. Examining the five comparability factors

The five comparability factors should, in our view, be first examined for the tested party. Not all of them will be relevant for every comparable search. The most relevant factors should be established based on the functional analysis and only these should be checked for the comparable companies as a priority.

In spite of the requirement of performing a functional analysis by the OECD, there are many occasions in practice when comparability analyses are performed without a functional analysis. We agree that such situations should be avoided, all the more that the likelihood for a comparability analysis to be inappropriate is higher when not grounded in a functional analysis.

- A (importance of missing information):

We agree with the view that missing information that is unlikely to have a significant impact on the profit generated by a transaction should not be used to reject the transaction, whereas missing critical information, such as information about the industry for example, should lead to rejecting it.

When information on one comparability factor is missing for one comparable company, we would suggest constituting two ranges of arm's length results: one with the company, one without (refined), and appreciating the gap between the two ranges. For example, it might not be possible to verify the position of the comparable company but in the absence of information showing that its position differs from that of the tested party, this company should not be rejected.

7. Selecting or rejecting third parties or third party transactions: degree of objectivity of the list of external comparables

- B (degree of objectivity: "additive" and "deductive" approaches):

Although we agree that the objective should always be to try to find the best data, we believe, because of the amount of subjectivity inherent to the "additive approach", and the higher risk of "cherry picking" associated with it, that the "deductive approach" should be preferred over the "additive approach". This, however, does not preclude the inclusion of well-known third party comparable transactions, as long as it is supplemented with a revision of the search steps so that these transactions can be included with an acceptable level of objectivity.

8. Determination of and making comparability adjustments where appropriate

Although we agree that there should be no exhaustive list of the adjustments that can be performed, we believe that more guidance regarding the different kinds of adjustments that are available, beyond capital intensity adjustments, would be useful.

- **C-1** (quality of data adjusted):

We agree that adjustments should be performed on good quality comparable data when the impact on profit of the difference being adjusted is quantifiable.

We understand that transactions between third parties with different business strategies or models, or operating in different geographic markets or industries than the tested party can be considered to be comparable as long as appropriate adjustments can be performed.

Regarding adjustments for companies operating in different geographic markets or industries, we believe that it should be possible to adjust the comparable data based on market or industry averages. The percentage differences between the averages of the third parties' and tested party's markets or industries respectively could be applied to the results of the given third parties before including them back in the sample of arm's length results. For example, if the average profit of the tested party's industry is 8% and that of the third parties' is 6%, the result of the third parties' could be increased by a factor of $\frac{8-6}{8} = \frac{2}{8} = \frac{1}{4} = 25\%$.

The differing impact of business strategies and/or models on profit could be adjusted similarly, albeit arguably more difficult to measure.

In any case, some guidance on acceptable adjustments by the OECD would be most welcome.

9. Multiple year data

- **B** (comments from the business community):

Regarding the computation of weighted averages, we believe that the weights to be used should be given due consideration. Turnover should, in our view, only be used as the weight (the most common situation in practice), when company sizes are relevant to their profit levels. If the company size is not relevant to its profit, using turnover as a weight results in a biased range of arm's length results.

- **C-1** (multiple year data and cycles):

We agree that judgement should be used regarding the length of the period to be covered by the analysis. For practical reasons, we believe that periods from three to five years could be considered. That being said, some de minimis guidance on the subject by the OECD would be useful.

We would welcome some guidance by the OCDE on how to account for different year ends across comparable companies and with the tested party. Let's consider a tested party with its year ends on 31 December and a comparable company with its year ends on 31 March. Whereas the accounts of the two companies for a given year n overlap only for the three months between 1st January and 31 March, the tested party's year n-1 accounts and the comparable company's year n overlap for the nine months between 31 March and 31 December of year n-1. On this basis, instead of comparing the tested party's year n accounts to the comparable company's year n account, we would recommend comparing the tested party's year n account with the comparable company's year n+1 accounts. The general rule would be to shift the years being compared as soon as the number of overlapping months between the tested party's and the comparable company's accounts is less than 6 months.

- **D-2** (statistical tools not to be confused with multiple year data):

Although the issue of statistical tools is distinct from the issue of multiple year data, in situations where few comparable data were identified, the use of multiple year data can be useful to expand the number of observations and thus increase the reliability of the analysis.

11. Definition of the arm's length range, extreme results, methods to enhance reliability, loss-making comparables

- **A** (definition of arm's length range):

Although we do agree with the fact that statistical tools cannot increase the reliability of a comparability analysis, we believe that they are useful in order to make sense of a range of arm's length results and/or to extract the most relevant point in an arm's length range of results.

- **B** (comparability considerations for extreme results):

Although it makes sense not to reject extreme results solely on the basis of their being extreme but on comparability grounds, we are not certain that it would be always cost effective to perform additional research for all comparable transactions with extreme results. That is why we would not outlaw a prudent approach, that would consist in rejecting the transactions with extreme results without undertaking further research, in situations where a sufficient number of comparable companies have been identified (say more than 20 for example).

- **C-2** (ranking the points in the range):

We consider that it should be possible to argue for a specific point in a range of arm's length results to be more applicable to the tested party. One could for example argue that the tested party is entitled to a profit, say tending to the upper side of the range, if it performs more functions, assumes more risks, or use more valuable assets than is generally the case for comparable companies in the industry. Some guidance on this matter in the OECD Guidelines would be welcome.

- **D** (loss-making comparables):

We agree on the analysis on loss-making comparable companies. Our position is that loss-making companies should not be automatically rejected.

If there is a drop in the industry cycle in some years, this would potentially be reflected by some independent companies making losses, while the rest of independent companies generate lower profits. Under such circumstances, excluding loss-making companies on the pure basis that they are loss-making would introduce an upward bias in the arm's length range of results.

Some tax administrations do not accept loss-making companies in samples of comparable companies. Although this position is understandable for companies with low risks, few assets or simple functions, it is less so for companies with some level of risks, some valuable assets, or slightly more complex functions, which could be loss-making despite meeting the five comparability factors, even in a normal situation.

Consistent losses observed for a comparable company should be viewed as a sign that further research is needed.

12. Documenting a search for comparables

- **B** (contributions from the business commentators):

We believe that the key principle in preparing a comparability documentation should be transparency, with the purpose of fairness and objectivity. Our view is that every relevant information that was used in performing the analysis and reaching a conclusion should be documented, without it being based on a prescriptive list of elements to be included, even though some guidance on de minimis elements to be included would be valuable.