

COMPARABILITY: PUBLIC INVITATION TO COMMENT ON A SERIES OF DRAFT ISSUES NOTES – RESPONSE TO THE OECD

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INTRODUCTION

The OECD Committee on Fiscal Affairs and specifically Working Party No. 6 which is responsible for transfer pricing first began its series of open consultations on transfer pricing and comparability issues in general in 2003. At that time, the business community responded with detailed contributions that have prompted a further investigation of comparability issues by the Working Party as part of its procedures for monitoring the implementation of the 1995 Transfer Pricing Guidelines.

The second phase of this consultation process began with an invitation to comment on issues related to profit methods was released on 28 February 2006 followed by another on May 10, 2006 which specifically dealt with comparability issues encountered when applying the transfer pricing methods authorized by the 1995 TP Guidelines. The second invitation to comment on comparability issues is notable in that this was an invitation to comment on a series of draft issues notes that were developed by Working Party No. 6 based on both the experience acquired by countries since the adoption of the Transfer Pricing Guidelines in 1995 and on comments received from the business community in response to the 2003 invitation.

The purpose of this article is to illustrate the OECD's stance on the various draft issues as conveyed in their invitation followed by comments that will hopefully add to fruitful discussion and eventually a better conception of the realities of practical implementation of the OECD Guidelines and eventually a better alignment of the practice of transfer pricing vis-à-vis theory.

DRAFT ISSUES

The present invitation of the OECD on comparability issues is certainly an attempt to address a broad range of issues concerning comparability in a transfer pricing context that are frequently encountered by taxpayers documenting their transfer prices. The scope of this review is immediately obvious by a quick summary of the table of contents in the OECD invitation which is illustrated below. A detailed summary of the OECD's comments on each issue and issue specific commentary will follow in the next sections.

- ❑ Putting a comparability analysis and search for comparables into perspective
- ❑ Timing issues in comparability
- ❑ Internal comparables
- ❑ Determination of available sources of information and of their reliability

- ❑ Uncontrolled transactions
- ❑ Examining the five comparability factors
- ❑ Selecting or rejecting third parties or third party transactions: degree of objectivity of the list of external comparables
- ❑ Determination of and making comparability adjustments where appropriate
- ❑ Multiple year data
- ❑ Aggregation of transactions
- ❑ Definition of the arm's length range, extreme results, methods to enhance reliability, loss-making comparables
- ❑ Documenting a search for comparables

ISSUE SUMMARIES AND COMMENTARIES

1.) PUTTING A COMPARABILITY ANALYSIS AND SEARCH FOR COMPARABLES INTO PERSPECTIVE

The Draft Issues addressed by the OECD begin with the reasons why comparability analysis and the search for comparables are so very important in the context of transfer pricing. In this context, the OECD is clear that “Comparability analyses are grounded in paragraph 1 of Article 9 of the Model Tax Convention and are essential to the application of the arm’s length principle.”¹

Based on this premise, the OECD goes on to assert that such comparability analyses “should not be limited to a mere search for comparables or a mere comparison of financial indicia” and that the comparable searches “should not be disconnected from the other steps of the comparability analysis, in particular the review of the conditions of the controlled transactions and the determination of the relevant comparability factors.”²

This OECD concern is driven by what it calls a “disconnect” between “linking the search for comparables and comparability analysis” which “may become more frequent as searches for comparables increasingly often rely on external comparables searched on a database, with an observed tendency to focus on comparisons of financial indicia.”³

In essence, the OECD is of the view that “putting comparability analyses and searches for comparables into perspective should serve the dual objective of putting greater emphasis on the quality of the analyses rather than on mechanical comparisons of financial indicia

¹ Paragraph 1 of Article 9 of the OECD Model Tax Convention is the authoritative statement of the arm’s length principle:

“[When] *conditions* are made or imposed between [...] two [associated] enterprises in their commercial or financial relations *which differ* from those which would be made between independent enterprises, *then any profits which would, but for those conditions, have accrued* to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.” [*emphasis added*]

Also See Comparability: Public Invitation to Comment on a Series of Draft Issue Notes, Center for Tax Policy and Administration, Organization of Economic Cooperation and Development, 10 May 2006, hereafter referred to as “OECD Invitation,” Page 4

² OECD Invitation, Page 8

³ OECD Invitation, Page 6

and reaching a standard that is reasonable and balanced in terms of the burden created for taxpayers and administrations.”⁴

In this context, the OECD is of the view that the “concept of “prudent business management” may be worth clarifying in the Guidelines.” Prudent business management, in the OECD’s interpretation, would ideally imply that taxpayers would be required to spend less time and effort to find detailed comparable third party information to support relatively small controlled transactions which may be measured relative to the size of the business. In addition, based on the “reasonable assessment” concept, the OECD has also touched upon the fact that it may be reasonable to not require extensive compliance effort, i.e. a detailed comparability analysis, from taxpayers each year to document transactions that are relatively simple and “that are carried out in a stable environment and the characteristics of which remain the same or similar” as long as taxpayers have a system to monitor and review these transactions every year.⁵

COMMENTARY

The issue of the disconnect between the comparability analyses and the search for comparables is certainly a very serious one in transfer pricing since such a disconnect impacts the integrity of the analyses itself. As the Working Party No. 6 has observed, it is important that any comparability analyses not be a mere search for comparables or a comparison of financial indicators without taking into account the spirit of the wording in Article 9. In essence, taxpayers have to carefully examine controlled transactions as the terms and conditions, economic circumstances etc. underlying them and compare them with uncontrolled internal or external transactions where they are available. Therefore, it is imperative that any transfer pricing analyses follow a procedure that evaluates comparability characteristics between controlled and uncontrolled transactions rather than immediately relying on the use of databases and financial indicators.

In this context, a very welcome development is the OECD’s recognition of the “prudent business management” concept in essence allowing taxpayers to focus their transfer pricing compliance efforts on the largest material and most complex transactions rather than devote valuable resources to prepare comprehensive analyses of simple and routine transactions. This certainly would help alleviate the large transfer pricing compliance burden already carried by taxpayers. Smaller taxpayers with simple transactions might especially benefit from this since they would only be required to monitor and review their transactions for consistency every year rather than prepare comprehensive documentation every year. Some OECD countries have already issued legislation that supports this view and many others may follow suit in the near future except perhaps the most aggressive jurisdictions.

2) TIMING ISSUES IN COMPARABILITY

The second issue raised by the OECD involves timing issues when performing comparability analyses and the different practices that exist with respect to such issues. In this context, the OECD has pointed to three main timing issues that crucially impact such analyses as follows:

- One issue relates to the point in time when information on comparable uncontrolled transactions is collected either by the taxpayer or by a tax administration.

⁴ OECD Invitation, Page 8

⁵ OECD Invitation, Page 7

- ❑ Another issue is whether information on uncontrolled transactions that is used in a comparability analysis always needs to pertain to the same year as the taxpayer's controlled transaction under review, or whether – and if so in what circumstances and to what extent – information pertaining to years prior or subsequent to the year of the taxpayer's controlled transaction can be used.
- ❑ A third issue relates to the point in time when information collected is produced by the taxpayer to the tax administration.

Addressing the first two issues alone (since the third was determined to be beyond the scope of the review), the OECD has touched the two main circumstances when timing issues come into play. The first scenario concerns the exercise performed by taxpayers to “identify third party comparables to support its future transfer pricing policy, e.g. as a routine exercise linked with the budgetary process, or as part of an APA negotiation.” The second case involves an ex post facto verification of transfer prices that “may be carried out to verify the consistency with the arm's length principle of prices actually charged for transactions already completed” either when the year-end tax return is filed or during an audit.⁶ In the first case, i.e. when transfer pricing analyses is conducted prospectively, there is also the additional problem of making retroactive adjustments when new information comes to light after transfer prices are set and whether they should be allowed to be performed.

In general, the OECD considers that ex-ante and ex post facto comparability analyses both have their place in the context of transfer pricing, albeit for different purposes. Specifically, it considers prospective documentation of transfer prices to be “consistent with Article 9 of the Model Tax Convention, which requires a comparison of the *conditions made or imposed* between the two related enterprises in respect of a transaction.”⁷ When such an approach is followed, the OECD also states that “it will be valuable to take into account the information (which would usually extend beyond external or third party data) that was available to the prudent business manager at the time that manager would have had to make such pricing decisions. As a result, documentation prepared in accordance with the prudent business manager principle at the time the transactions are organized could include market information, internal comparables where they exist and could be completed by external comparables where appropriate.”⁸

The OECD asserts that the main purpose and emphasis of documenting transfer prices ex post facto is to test the *outcome* of a taxpayer's controlled transactions.⁹ The OECD looks at this approach not as a substitute for upfront pricing practices and documentation but more as a complementary exercise. In addition, the OECD also cautions that in some circumstances ex post facto documentation can be impractical either due to non-availability of third party comparable data or differences in how transacted amounts are accounted for under the legal accounting guidelines and for tax reporting purposes.

On the issue of ex post facto review of transfer prices and retroactive adjustments, the OECD is of the opinion that such adjustments may be permissible but only when there is an economic imperative, i.e. a change in the economic environment that necessitates such adjustments. In essence, the OECD expects that such an adjustment be made even where the taxpayer has met the documentation requirements for each period of the analysis and

⁶ OECD Invitation, Page 11

⁷ OECD Invitation, Page 12

⁸ Ibid.

⁹ OECD Invitation, Page 13

in addition, taxpayers are expected to put in place proper mechanisms “to allow appropriate adjustments and limit risks of double taxation and penalties.”¹⁰

COMMENTARY

Without doubt, timing issues are very important in the context of a transfer pricing analyses the OECD’s seriousness to address this issue does certainly bode well for taxpayers. Timing issues impact both ex-ante transfer pricing planning activities as well as transfer pricing compliance since most jurisdictions expect documentation to be completed at the time of filing the tax returns.

In general, the OECD’s preference for ex-ante transfer pricing analyses reflects the reality of how business is conducted since most business and pricing decisions are usually made prospectively. It is also refreshing to note that the OECD recognizes the fact that economic circumstances do not change dramatically from year to year. In this context, the OECD also takes an enlightened approach on permitting retroactive adjustments, i.e. it allows them only when there is an justifiable economic rationale to do so rather than on an arbitrary basis.

3) INTERNAL COMPARABLES

Although the OECD Guidelines do not specifically define “internal comparables” per se the draft issues notes clarify that references to “comparable uncontrolled transactions” in the OECD Guidelines implicitly refers to both internal and external comparable transactions. Internal comparable transactions are understood to mean “comparable transactions between the taxpayer and a non-related party” while external comparable transactions are understood as occurring “between an independent enterprise and a non-related enterprise.”¹¹

Although the OECD points out that there is “an increasing use of external comparables (in particular using commercial databases) rather than internal ones” it is very clear that it has a general preference that internal comparables should be evaluated and if possible used in a comparability analysis before external comparables are considered.¹² That said, the OECD also cautions against using internal comparables that are not reliable. In other words, the OECD has pointed out that “the general preference for internal comparables over external ones is grounded in the potential advantages internal comparables are likely to present as described in paragraph 9 above. It is not however an absolute hierarchy and it has to be appreciated on a case by case basis in light of the objective to find the best available and reliable comparables.”¹³

The OECD also illustrates the use of internal comparables vis-à-vis external comparables in particular situations. For instance, when applying the comparable uncontrolled price (CUP) method, the OECD asserts that “because of the significance of product similarity when applying the comparable uncontrolled price method, internal comparables have the potential of providing better CUPs than external ones.”¹⁴ On the other hand, the OECD also points out that “given the current hierarchy of methods in the Guidelines, the transactional net margin method is applied by taxpayers and tax administrations mostly using external comparables.”¹⁵ In the same vein, the OECD has also expressed its distinct

¹⁰ OECD Invitation, Page 16

¹¹ OECD Invitation, Page 18

¹² OECD Invitation, Page 19

¹³ OECD Invitation, Page 20

¹⁴ Ibid.

¹⁵ Ibid.

preference for the use internal comparables, particularly when determining arm's length remuneration for transactions involving intangibles and intra-group services.

From a documentation standpoint, the OECD considers the evaluation of internal comparables and their documentation to be very important to establish that a taxpayer has followed an "objective" selection process. Therefore, the OECD considers it "reasonable to expect from taxpayers that they clearly indicate:

- Either the reason for not using internal comparables where that is the case (e.g. because they have no internal comparable transactions, or because their uncontrolled transactions were not regarded as valid comparables due to material differences that could not be adjusted),
- Or, in cases where some internal comparables are used, all the relevant information with respect to the comparability factors and the selection process."¹⁶

COMMENTARY

The OECD's general preference for internal comparables over external comparables is certainly not surprising especially given that it has always considered internal comparables to be most reliable than external comparables which are obtained from commercial databases. That said, the practical reality that confronts many taxpayers is the availability of internal comparables and even if they are available, their comparability to the situation at hand. Notwithstanding this fact, the OECD's explicit preference for internal comparables does mean that taxpayers would be well advised to consider using internal comparables in their transfer pricing analyses, even if such internal comparables are imperfect. Indeed, it may be far better to use imperfect internal comparables and attempt to make the necessary adjustments rather than risk the charge that reasonable efforts have not been made.

The OECD's comments do appear to indicate that internal comparables are preferred in almost every case, including when applying the CUP method or any of the other transactional methods as well as when determining transfer prices for intangibles and intra-group services. In addition, the OECD's preference that taxpayers document their search and elimination of internal comparables in their transfer pricing analyses drives home the point that taxpayers should ensure that all potential internal comparables should be discounted before using external comparables. Indeed, this is especially pertinent for taxpayers using the TNMM to justify their transfer prices since it is considered a method of last resort as well as a method that exclusively uses external comparables, which are certainly not the first choice for the OECD. Such thorough documentation will help prove to tax administrations that a taxpayer has followed an "objective" selection process rather than resort to a less preferred method without adequate due diligence of possible internal comparables.

4) DETERMINATION OF AVAILABLE SOURCES OF INFORMATION AND OF THEIR RELIABILITY

On the issue of determination of available sources of information and their reliability when performing comparability analyses, the OECD has identified the following main sources:

- "A - Informal and confidential information on third parties;
- B - Databases that mainly compile accounts filed by companies.

¹⁶ OECD Invitation, Page 21

C - Public information such as industry surveys performed by financial analysts and annual reports published by listed companies for regulatory purposes and shareholders' information and information displayed on companies' websites.

D - In addition, the use of foreign source or non domestic comparables deserves specific comments.”¹⁷

Commenting on informal and confidential information on third parties that is available to both taxpayers, the OECD is of the view that confidential information “that confidential information obtained by taxpayers would not be appropriate to support their transfer pricing policies” especially since they raise “a major concern relating to its reliability and auditability.”¹⁸

In the same vein, the OECD is generally not in favor of confidential information used by tax administrations, especially the use of the so called “secret comparables” that have been quite controversial in almost every jurisdiction that has attempted to use them. In this context, the OECD's stance is that “...ideally the OECD preference is not to use “secret comparables” but it is recognized that in practice some countries do use them, particularly in situations where publicly available comparable information is limited.”¹⁹ The OECD also advises countries that use “secret comparables” in audits “to develop appropriate safeguards in their domestic legislation or practices, aiming at ensuring reasonable fairness and reliability for taxpayers.”²⁰ Notwithstanding this stance, the OECD has made a clear distinction between their use in competent authority procedures and their use in transfer pricing adjustments since competent authority procedures involve dealings between two tax administrations that are at liberty to disclose them to reach a settlement.

On the issue of databases, the OECD clearly has serious concerns about the reliability and quality of information available from such databases. Distinguishing between commercial and proprietary databases developed by consulting firms, the OECD considers proprietary databases to be more problematic especially since they are concerns about reliability, quality and exhaustivity of data contained in such databases. More importantly, the OECD asserts that “when a taxpayer intends to support its transfer prices with such a proprietary database, the tax administration may request access to the database for obvious transparency reasons.”²¹ If such access is not provided, the information derived from the proprietary database may qualify as confidential information and be disallowed in an audit proceeding.²²

With regard to commercial databases, the OECD is of the opinion that they “should be used only when they add value to the comparability analysis and that it should not be required in cases where better information can be obtained from other sources.”²³

On the third issue, i.e. the use of public information, the OECD is of the opinion that “publicly available information can be usefully used to complement and improve the quality of a search that is primarily performed on a commercial database.” On the use of foreign source and non-domestic comparables, the OECD recommends their use based on

¹⁷ OECD Invitation, Page 24

¹⁸ Ibid.

¹⁹ OECD Invitation, Page 26

²⁰ Ibid.

²¹ OECD Invitation, Page 28

²² Ibid.

²³ Ibid.

the consideration of the relative market differences and whether reliable adjustments can be made to alleviate material differences.²⁴

COMMENTARY

The OECD's stance on the use of "secret comparables," i.e. that it generally prefers that they not be used is certainly very welcome from a taxpayers' perspective and it is certainly the hope of this author that some of the more aggressive tax administrations take cues from the OECD's pronouncements in this draft issues notes and amend their domestic legislation to prohibit the use of such confidential information. The use of secret comparables runs counter to all notions of fairness and symmetry between taxpayers and tax administrations that are so fundamental to the effectiveness of a taxation regime. It also does little to ensure at least some level of fair dealings between taxpayers and tax administrations. Therefore, the OECD has taken the right step in stating that it does not prefer the use of secret comparables.

On the use of proprietary databases, the OECD's concerns are well founded and generally it is not a good idea to perform an entire comparability analyses using a proprietary database unless the taxpayer can ensure that tax administrations have access to such databases. Given that most of these databases have been developed by the major accounting firms and used to prepare transfer pricing studies for a number of their clients, one can speculate whether tax administrators will be granted access to such databases in the event of an audit. Indeed, it is in the best interest of the taxpayers to ensure that their transfer pricing advisors do not overly rely on their proprietary databases since this may cause audit issues in the future.

With regard to commercial databases, although the OECD's concerns are justified, it is certainly a fact that such databases have become increasingly sophisticated and comprehensive especially in certain regions of the world, i.e. North America (USA and Canada). Often taxpayers and their advisors are forced to use commercial databases primarily because better information cannot be obtained from other sources. Nonetheless, it would be prudent for taxpayers to document this fact in their transfer pricing reports in order to ensure that tax administrators understand the underlying rationale behind the use of such databases.

Finally, as advised by the OECD, the use of other public information should always be considered where they add value and so should non-domestic information especially when adequate information is not available in a single country.

5) UNCONTROLLED TRANSACTIONS

This issue primarily concerns the availability of true uncontrolled transactions, i.e. transactions between independent enterprises that can be reliably used for comparability analyses, especially in industry sectors that are highly vertically integrated. Although the OECD does concede that it may be a challenge to find uncontrolled transactions in some vertically integrated industries, it is clearly not in favor of using data from controlled transactions since it runs counter to wording in Article 9 of the Model Tax Convention.²⁵ In the same vein, the OECD is also clear that any broad based surveys of subsidiaries of multinational enterprises should only be used as a "sanity check" to corroborate the results

²⁴ OECD Invitation, Page 29

²⁵ OECD Invitation, Page 31

obtained by the use of one of the approved transfer pricing methods rather than on a stand-alone basis.²⁶

In this context, then, the OECD has proposed alternative options when uncontrolled transactions are not available in a specific industry. Some of the alternatives proposed include broadening the search for comparables by including comparables in the same industry that operate in slightly different economic circumstances, in the same industry but in different geographic markets and finally in the same geographic region but in different but related industries provided reliable adjustments can be made.²⁷ Another alternative proposed was the examination of uncontrolled transactions entered into by multinational groups.²⁸ A third alternative would be to use consolidated data although its application in practice was considered to be rather minimal.²⁹ Finally, the OECD also considered the influence of minority shareholders on the arm's length nature of a company's transactions. In this context, the OECD concluded that the "presence of minority shareholders is one of the elements that may be taken into account in the analysis, it is not sufficient of and by itself to draw a conclusion."³⁰

COMMENTARY

The issues surrounding the availability of uncontrolled transactions is certainly a very important one, especially in vertically integrated industries and in a world where most international transactions happen between related entities of the same multinational group. The OECD is patently clear that it does not allow the use of controlled transactions which is understandable given the wording of Article 9.

Nonetheless, the alternatives it has proposed, while certainly feasible would have to be implemented by diluting the comparability standards. And, this may be an issue that needs to be clarified more by the OECD. For instance, although it may be reasonable to make a case for comparables within the same industry but in different geographies, to make the same case for comparables in a related industry in the same geography may be more difficult especially since reliable adjustments cannot be made in such situations. In this context, therefore, taxpayers have to be very careful to document why they chose one of the alternatives over the other since not doing so may potentially give rise to a tax exposure.

6) EXAMINING THE FIVE COMPARABILITY FACTORS

The OECD Guidelines (in paragraphs 1.19 to 1.35) delineate five factors to be considered when determining comparability for all transfer pricing methods as follows:

1. Characteristics of property or services
2. Functional analysis
3. Contractual terms
4. Economic circumstances
5. Business strategies³¹

²⁶ OECD Invitation, Page 32

²⁷ Ibid.

²⁸ Ibid.

²⁹ OECD Invitation, Page 33

³⁰ OECD Invitation, Page 34

³¹ OECD Invitation, Page 35

The OECD Guidelines stipulate these five factors be examined in relation to both the controlled transactions as well as the uncontrolled transactions. However, in practice, “the level of detail in the information available to a taxpayer on the factors affecting external comparable transactions is very often less than for its own transactions” and this difference, the OECD acknowledges is not “properly acknowledged in the Guidelines.”³² Nonetheless, the OECD’s Working Party has concluded that “as a matter of principle a less rigorous analysis of third party transactions would not be acceptable, but that in practice the detail of information needed on each of the five comparability factors affecting the transactions of a third party needs to be assessed on a case by case basis.”³³ In essence, the OECD requires that taxpayers make their best efforts to assess third party comparables vis-à-vis the five comparability factors by performing an analysis that “goes beyond some vague categorization of one of the parties to the controlled transactions followed by the use of lightly-examined comparable companies derived from a public database.”³⁴ In addition, the taxpayer is expected to evaluate whether the absence of information on one or more of the factors materially affects comparability to assess whether or not to include the comparable for analysis.³⁵ The OECD then goes on to examine the specifics of each of the five comparability factors.

COMMENTARY

In essence, the primary message from the OECD in this issue note on the five key comparability factors to be taken into account in any transfer pricing analysis is that their evaluation is crucially important for a rigorous comparability analysis. Indeed, to discount any one of them or perform a cursory analysis of any one or more of these factors would only diminish the reliability of the analysis. In addition, where adequate information is not available on any one or more of these factors, the taxpayer has to ensure that such lack of information does not materially impact comparability, thereby diminishing the integrity of the analysis.

The OECD has certainly set a high standard for comparability by its insistence that the rigorousness of a comparability analyses is predicated on the thorough examination of all five of the factors outlined in the OECD Guidelines. While one could certainly debate the relative importance of these various factors in the context of a comparability analyses and how well they can be evaluated in practice, but the OECD’s premise seems to be that this is a crucial step in the comparability analyses which cannot be compromised on. It remains to be seen how businesses react to the OECD’s stance especially considering the lack of proper information on evaluating all five of these factors in a majority of transfer pricing situations.

7) SELECTING OR REJECTING THIRD PARTIES OR THIRD PARTY TRANSACTIONS: DEGREE OF OBJECTIVITY OF THE LIST OF EXTERNAL COMPARABLES

When selecting comparables, the Working Party has described a logical sequence of steps that are required to be completed when searching information on comparable transactions. “Typically, this sequential order may be described as follows:

³² OECD Invitation, Page 35

³³ OECD Invitation, Page 36

³⁴ Ibid.

³⁵ Ibid.

- Step 1: Broad based analysis (e.g. industry analysis, analysis of value-drivers, nature of the competition experienced and economic and regulatory factors).
- Step 2: Determination of years to be covered.
- Step 3: Review of the controlled transaction(s) under examination, in order to identify the relevant factors that will influence both the choice of the appropriate method(s) and the comparability analysis, in particular the scope, type, value and timing of the controlled transaction(s), as well as information on the five comparability factors (characteristics of property or services, functional analysis, contractual terms, economic circumstances and business strategies).
- Step 4: Review of existing internal comparables. Where necessary (i.e. where satisfactory internal comparables are not available), decision to look for external comparables.
- Step 5: Determination of available sources of information on external comparables where such external comparables are needed (including but not limited to commercial databases) and of their reliability.
- Step 6: Choice of the relevant transfer pricing method(s) and, depending on the method(s), definition of the relevant indicia (e.g. definition of the relevant net profit indicator in case of a TNMM).
- Step 7: Identification of potential comparables: defining the key characteristics to be met by any uncontrolled transaction in order to be regarded as potentially comparable, based on the relevant factors identified in Step 3 and in accordance with the comparability standards set forth in paragraphs 1.19 to 1.35 of the Guidelines (i.e. functional analysis, economic circumstances, etc.).
- Step 8: Determination of and making comparability adjustments where appropriate.
- Step 9: Interpretation and use of data collected, determination of the arm's length remuneration.
- Step 10: Implement support processes. Install review process to ensure adjustment for material changes and document these processes.³⁶

Although the above steps are illustrative in nature, they do represent a very tangible step in guiding taxpayers on how to approach the search for comparables especially when applying the cost plus, resale minus or transactional net margin method.

In addition, the Working Party has also provided further guidance on Step 7 above which it considers to be “one of the most critical - it requires the exercise of judgment and is potentially a very subjective exercise, hence the need to ensure some degree of objectivity and transparency.”³⁷ In essence, the OECD defines two different approaches to identification of potentially comparable third parties, the “additive” and “deductive” approach. In the “additive” approach, the taxpayer draws up a list of third parties that are considered to be carrying out potentially comparable transactions and collecting information to determine whether they are in fact comparable. This approach, however, may not “offer a full picture of a taxpayer’s industry and therefore might potentially permit “cherry-picking” of the most favourable external comparables.”³⁸ The second approach, i.e. the “deductive” approach, “starts with a wide set of companies that operate in the same sector of activity, perform similar broad functions and do not present

³⁶ OECD Invitation, Page 45-46

³⁷ OECD Invitation, Page 46

³⁸ OECD Invitation, Page 47

economic characteristics that are obviously different.”³⁹ This search is usually performed using a database and then the “list is refined using publicly available information (databases, internet sites, taxpayer’s knowledge of its competitors) and, in particular, using qualitative criteria such as those relating to product portfolios and business strategies.”⁴⁰

In this context, the Working Party considers that “it would not be appropriate to give systematic preference to one approach over the other one because, depending on the circumstances of the case, there could be value in either the additive or the “deductive” approach, or in a combination of both. The objective should always be to try to find the best available data.”⁴¹ In addition, the OECD considers that the use of these two methods need not be used exclusively and their use in tandem can in fact improve the quality of the comparables.

Finally, the Working Party is of the opinion that “the quality of a comparability analysis can only be assessed if it is reproducible i.e. in particular:

- the process followed and criteria used to select or reject comparables (step 7 of the typical process described in paragraph 1 above) is clearly documented,
- and the person reviewing it (taxpayer or tax administration) can have access to the same sources of information.”⁴²

COMMENTARY

The steps for identifying comparables in this issues note is perhaps the most clear and comprehensive guidance offered as part of the consultation process. That also makes it the most concrete official guidance provided by the OECD thus far to taxpayers and hopefully this sort of transparency and clarity is retained when the 1995 Guidelines are eventually recrafted.

In terms of the other issues, i.e. the additive and deductive approaches to select comparables and transparency and reproducibility of the process followed to select or reject comparables, the OECD has taken the right approach in striking a good balance on the former issue and insisting that quality of a comparability analysis can only be assessed if it is reproducible in the latter issue.

8) DETERMINATION OF AND MAKING COMPARABILITY ADJUSTMENTS WHERE APPROPRIATE

On the issue of comparability adjustments, the OECD’s Working Party does state that “the existing guidance is limited in the Guidelines on how to handle comparability adjustments in practice.”⁴³ In this context, the Working Party classifies comparability adjustments into three categories, accounting adjustments, balance sheet or asset intensity adjustments and other types of adjustments. In commenting on these adjustments, the OECD is of the opinion that “adjusting data related to third party transactions where the functions performed or risks assumed differ from those in the taxpayers’ controlled transactions does not necessarily provide improvement of comparability.”⁴⁴

³⁹ Ibid.

⁴⁰ Ibid.

⁴¹ Ibid.

⁴² OECD Invitation, Page 48

⁴³ OECD Invitation, Page 49

⁴⁴ OECD Invitation, Page 52

In essence, the OECD proposes that “comparability adjustments should only be considered where they can be expected to increase the reliability of the results.”⁴⁵ In this context, the quality of adjusted data, purpose and reliability of the adjustment performed are all important issues to consider before an adjustment is made. It is also important that such comparability adjustments are adequately documented for submission to the tax authorities.

Given the limited guidance on comparability adjustments, the OECD Working Party has concluded the following:

- “Expand the existing guidance and develop a common platform of principles and concepts that ought to be adopted in performing comparability adjustments, including the circumstances under which they would typically be undertaken...
- Develop guidance on working capital adjustments, as this is the most commonly observed comparability adjustment. In practice, several ways to calculate the working capital adjustments are being proposed by taxpayers. Working capital adjustments are also based on the selection of an appropriate interest rate.”⁴⁶

As a first step, the Working Party has also included an example of a working capital adjustment in an annex to this issues note.

COMMENTARY

Indeed, as pointed out by the OECD Working Party themselves, guidance on comparability adjustments is certainly lacking in depth and detail in the Guidelines. In fact, such guidance is sorely needed given the fact that there are varying and often inconsistent interpretations by tax administrations, taxpayers and their advisors on what constitutes a “reasonably accurate adjustment” as well as how to perform them.

In addition, there are a wide variety of formulae for performing even some of the commonly applied adjustments such as the working capital adjustments leading to inconsistency among taxpayers within any specific jurisdiction itself. In this context, therefore, the OECD’s impetus to provide more guidance as well as greater transparency into adjustments and how they are made is particularly welcome. Finally, the Annex to the issues note on how to perform working capital adjustments is the first time the OECD has come out openly to illustrate how these adjustments should be made. Indeed, such transparency will not only ensure that taxpayers understand what is expected of them but also alleviate some of the misconceptions on how complex adjustments really are in a transfer pricing comparability analyses.

9) MULTIPLE YEAR DATA

The use of multiple year data has always been a controversial issue in transfer pricing circles and the OECD Working Party’s issue note is one attempt to address this issue. The Working Party recognizes that the use of multiple year data is quite common in practice and its opinion on the issue is summarized in the following points:

- “multiple year data should be used where (and only where) using it adds value to the transfer pricing analysis,

⁴⁵ Ibid.

⁴⁶ OECD Invitation, Page 55

- it is not a systematic requirement as it is not always useful, although in practice situations where use of multiple data will not be of some use in a comparability analysis are likely to be limited,
- it should not be confused with the use of statistical tools. In particular, there will be cases where multiple year data are found useful to obtain a broader understanding of the context of a transaction, without such multiple year data being necessarily part of a mathematical determination of the arm's length range.”⁴⁷

In essence, the Working Party has clarified that the use of multiple year data may be useful in the following three scenarios: first, where a taxpayer's transactions are affected by economic/business or product cycles; second, to evaluate a reasonable period of time for an enterprise to sustain loss making transactions; and third, to test volatility and anomalies in third party information.

In this context, the main conclusions reached by the Working Party on the use of multiple year data are as follows:

- “Complete paragraphs 1.49-1.51 by providing illustrations of situations where multiple year data may be useful.
- Clarify that the OECD recognition of the usefulness in some circumstances of multiple year data is not intended to contradict domestic examination procedures with regard to yearly assessment of taxpayers' results,
- Clarify that the OECD recognition of the usefulness in some circumstances of multiple year data is a separate issue from the one of statistical tools and accordingly amend paragraph 3.30.”⁴⁸

COMMENTARY

Given the fact that the use of multiple year data has been debated quite extensively within the transfer pricing community, the Working Party's attempt to clearly define when the use of multiple year data is acceptable is certainly a welcome development. Notwithstanding this, the Working Party has also been very careful to state that its recognition of usefulness of multiple year data in certain specific circumstances is not intended to contradict domestic yearly examination procedures adopted by individual tax administrations thereby opening the doors for tax administrators to set their own specific rules on the acceptability of the use of multiple year data in their jurisdictions.

This obviously raises issues for multinational taxpayers who operate in a number of jurisdictions and one can potentially envision a scenario where two key entities are operating in different jurisdictions, one of which allows for the use of multiple year data and the other accepts only yearly comparisons. Therefore, it is imperative that the OECD clarify its stance on the issue when such conflicts do occur since they will be inevitable if both stances, i.e. the use of multiple year data and the use of yearly assessments are adopted as equally valid. An additional concern is how taxpayers should satisfy domestic legislation on a yearly basis when there is inadequate data to perform the analysis on an yearly basis. In such cases, it is important to clarify whether it is reasonable to use multiple year data as a proxy.

10) AGGREGATION OF TRANSACTIONS

⁴⁷ OECD Invitation, Page 60

⁴⁸ OECD Invitation, Page 63

The OECD’s view on the aggregation of transactions is essentially that “the requirement of a transactional analysis should be retained as the starting point in any comparability analysis, and that more guidance may be necessary on how aggregated information on third party transactions could best be used within this framework.”⁴⁹ Citing the fact that OECD countries believe that aggregation of data “reduces the reliability of a comparability analysis, and that a transactional analysis would generally be preferred where transactional data are available.”⁵⁰ However, where such transactional data is not available, the Working Party concedes that “aggregated comparable data should be used, but only where its use provided the most reliable available evidence to inform the arm’s-length nature of transfers between associated enterprises.”⁵¹

In sum, the Working Party concedes that taxpayers may be forced to aggregate transactions when reliable transactional data is not available for analysis in practice. Nonetheless, the OECD requires proper documentation of the reasons for aggregation insisting that “where a taxpayer considers that its own transactions or the transactions of third parties can be validly aggregated, the reasons for such an aggregation should be made explicit in the transfer pricing documentation.”⁵²

COMMENTARY

In an ideal world, there would be no need to aggregate transactions for transfer pricing purposes. However, given that we live in an imperfect one where availability of good data is a never ending concern, aggregation of transactions becomes an alternative that one has to resort to rather than one actively chooses. In this context, then, the OECD’s flexibility on the issue is illustrative of the fact that the Working Party members understand the practical difficulties in comparing non-aggregated controlled and uncontrolled transactions, the proverbial “apples to apples” comparison. Therefore, it is prudent that the Working Party has allowed a measure of flexibility rather than hold taxpayers to an impossibly high standard of comparability.

11) DEFINITION OF THE ARM’S LENGTH RANGE, EXTREME RESULTS, METHODS TO ENHANCE RELIABILITY, LOSS-MAKING COMPARABLES

In this particular issues note, the OECD Working Party addresses an number of important issues including the definition of an arm’s length range, impact of extreme results, methods to enhance reliability and consideration of loss-making comparables.

Pointing out that the arm’s length range is defined in paragraphs 1.45 to 1.47 of the 1995 Transfer Pricing Guidelines, the Working Party does concede that the theoretical definition of an arm’s length range, i.e. “in the sense that each point in the range is equally comparable, are rarely found in practice. It is more common to encounter an approximation of an arm’s length range, often developed through use of a transactional profit method.”⁵³ In this context, the OECD is clearly not in favour of using statistical tools as a substitute for comparability analysis to define an arm’s length range emphasizing “that the application of statistical tools or other approaches to an arm’s length range is not intended to make up for low quality of comparables – i.e. the idea is not to replace quality with quantity.”⁵⁴ Instead, the Working Party would like taxpayers to

⁴⁹ OECD Invitation, Page 66

⁵⁰ Ibid.

⁵¹ Ibid.

⁵² OECD Invitation, Page 68

⁵³ OECD Invitation, Page 69

⁵⁴ Ibid.

analyze the observations in the range “based on comparability criteria determined during the functional and economic analysis of the related party transaction under review.”⁵⁵

In terms of one the other issues related to the definition of a range, i.e. extreme results, the OECD’s view is that such extreme results should be further examined to determine the reasons that contribute to such a result, i.e., a defect in comparability, or exceptional conditions met by an otherwise comparable third party. In both cases, the OECD recommends that taxpayers exclude such extreme results.

In terms of the methods used to enhance the reliability of the arm’s length range and particularly statistical methods, the Working Party points to the fact that there is “consensus among OECD countries that statistical tools cannot replace the comparability analysis and in any case recourse to statistical tools, where acceptable, would only come after the review of comparability factors. Use of statistical tools should not be encouraged unless they demonstrably enhance the quality of the analysis.”⁵⁶ In addition, the Working Party also points to the fact that “one further point of general consensus is that statistical tools are often inappropriate for relatively small samples of data as they require a sizeable population of observations to be meaningful.”⁵⁷ In this context, although the OECD does not explicitly discount the use of a statistical method such as the interquartile range, it does emphasize the fact that in those countries where it is used, “the interquartile range is a tool that is meant to facilitate, rather than replace, judgment.”⁵⁸ Where statistical methods are not acceptable, taxpayers are expected to rely on rigorous comparability analyses to select comparables and use the full range of results.

Finally, in a somewhat controversial deviation, the Working Party states that taxpayers should consider ranking comparables within the arm’s length range on the basis of comparability by using “a multidimensional analysis involving a number of comparability factors.”⁵⁹ The practicality of such ranking is of course very much open to debate.

Finally, on the issue of loss making companies, the OECD is of the view that they should no be automatically excluded from the comparability analyses except in one of the following situations: first, when losses do not reflect normal business conditions; and second, when “where the losses incurred by third parties reflect a level of risks that is not comparable to the one assumed by the taxpayer in its controlled transactions.”⁶⁰ Interestingly, the OECD view is also congruent with the view of most of the business commentators who contributed to the 2003 invitation.

COMMENTARY

In this particular issue note, the OECD has hit on a number of key issues that have been a bone of contention between taxpayers and tax administrators throughout the OECD. Although the OECD’s Working Party is fairly clear in its stance the definition of the arm’s length range, on extreme results and loss making companies, its dual stance on accepting both the interquartile range in some jurisdictions and the entire range in others is somewhat perplexing since it would lead to inconsistencies within the OECD itself.

In fact, one could potentially envision disputes arising from this dual acceptance wherein one tax administration may maintain that all observations in the full arm’s length range are valid whether a different tax jurisdiction would only accept observations within the

⁵⁵ *ibid.*

⁵⁶ OECD Invitation, Page 71

⁵⁷ *Ibid.*

⁵⁸ OECD Invitation, Page 72

⁵⁹ *Ibid.*

⁶⁰ OECD Guidelines, Page 73

interquartile range. Indeed, it is not very clear how the OECD's Working Party might deal with this contradiction.

Another issue is the Working Party's stance on ranking comparables within the arm's length range which has itself been developed through a comprehensive comparability analysis. Ranking comparables within a range raises several issues, chief of which is which comparability factors to consider and how to determine their importance. In addition, even if a taxpayer were to undertake this exercise, there is no guarantee that a tax administration will not disagree with the ranking or the assumptions underlying such a ranking. Given the subjective nature of this whole exercise, it is imperative that the OECD Working Party more clearly explain why such a ranking is necessary and define some common standard for performing a "multidimensional" ranking exercise based on a variety of comparability factors.

12) DOCUMENTING A SEARCH FOR COMPARABLES

The final issue note concerns documenting a search for comparables and in this context, the OECD has highlighted the fact that most business commentators have expressed a preference for "more developments in the TP Guidelines to clearly emphasize the need for documentation and an explanation of the search process, while taking into account some of the inherent difficulties in obtaining publicly available information in various jurisdictions."⁶¹

Given these concerns, the OECD has concluded that it "might develop guidance on how a transfer pricing analysis might best be structured to evaluate and use external comparable data. The steps outlined in the note on "Selecting or rejecting third parties or third party transactions: degree of objectivity of the list of external comparables" might provide a useful framework for such guidance."⁶²

COMMENTARY

The OECD's conclusion that additional guidance may be necessary to taxpayers on how a transfer pricing analysis might be best structured is certainly a welcome initiative which will contribute immensely to standardizing the form and content of a transfer pricing analysis within the OECD. Given that the steps outlined in the note on "Selecting or rejecting third parties or third party transactions: degree of objectivity of the list of external comparables" are among the most comprehensive guidance proposed by the OECD, to start with this framework will certainly be welcomed by the business community.

CONCLUSIONS

In conclusion, the second invitation on comparability issues from the OECD's Working Party No.6 does appear to be a concerted and more pragmatic approach to resolving some of the key practical difficulties of applying the arm's length principle. The drafts issues memo does show a good grasp of practical difficulties that are faced by taxpayers when performing transfer pricing analyses and it is heartening to see that the OECD has begun to offer more concrete and comprehensive guidance than what was available before. This is especially important considering that the OECD Guidelines has in fact become the "bible" of transfer pricing, if you will in almost every major tax jurisdiction within the OECD. Certain controversial issues do remain unresolved but a great many of them appear to be heading

⁶¹ OECD Guidelines, Page 78

⁶² Ibid.

towards a resolution that will satisfy both taxpayers as well as tax administrations. In the end, greater transparency and better guidance on transfer pricing will only assist taxpayers to ensure that their transfer pricing policies are at arm's length, enhance greater compliance from taxpayers and assist tax administrators to properly administer the arm's length principle in their respective jurisdictions.