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To Jeffrey Owens
Director of the OECD Centre for Tax Policy and Administration

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From KPMG's Global Transfer Pricing Services, contact Clark Chandler or Andrew Hickman

Ref Memo to Jeffrey Owens Director of the OECD Centre for Tax Policy and Administration.docx

Comments on the OECD's Proposed Revision of Chapters I-III of the Transfer Pricing Guidelines

KPMG[1] welcomes the opportunity to submit comments on the OECD's proposed revisions to Chapters I – III of the transfer pricing guidelines (hereinafter referred to as the "Proposed Guidelines"). As an opening comment, KPMG believes that these revisions go a long way to bringing the OECD Transfer Pricing Guidelines into step with current transfer pricing practices. The elevation of the net profits methods and, in particular, removing the stigma attached to the transactional net margin method (TNMM) is welcome developments. KPMG very much appreciates the effort that the OECD has put into these revisions, and believes that they are, in general, a substantial improvement upon the 1995 Guidelines.

That said, KPMG believes that that there are various specific ways in which the proposed revisions fail to provide appropriate guidance, or provide guidance that is likely to be misused by at least some local tax authorities, and therefore should be revised. These recommendations are provided below.

Selection of Method

Allowing taxpayers and tax authorities to select the transfer pricing method that works best given the particular facts and circumstances of the transaction at issue rather than listing a priority of methods is a welcome development. However, the level of analysis needed with respect to the selection of method is an area of concern. In particular, the "most appropriate method" requirements set forth in paragraph 2.1 and elaborated upon in paragraph 2.7 give ambiguous guidance on this point. Similarly, paragraph 2.11 seems to allow a tax authority to apply a second method to reassess results obtained based on the method selected by the taxpayer.

KPMG believes that the Proposed Guidelines should be revised and reconsidered in the following ways.

- Clarify that the taxpayer should be allowed to select and use a method that is practical and which gives an appropriate result without an exhaustive search for or consideration of

[1] Throughout this document, "KPMG" ["we," "our," and "us"] refers to KPMG LLP's Global Transfer Pricing Services group. It does not refer to KPMG International, a Swiss cooperative.

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all possible methods. Therefore, the term "most appropriate method" should be replaced with "appropriate" method, with the qualification that there is no other method that is obviously superior to the method used. For example, there should be no requirement for an extensive search for, evaluation of, and rejection of CUPs when it is clear that such a search would be time consuming and expensive while a TNMM would be straightforward and would result in intercompany pricing that is consistent with the taxpayer's facts and intercompany arrangements. The guidance provided in paragraphs 2.7, 2.11 and 3.5 should be clarified in this regard.

- KPMG is particularly concerned with the statement in paragraph 2.108, which states, "… it might be useful in some circumstances to corroborate the conclusion of a transactional net margin method with a transactional profit split method, in order to avoid having a disproportionate amount of an MNE's overall profit from the controlled transactions accruing to the tested party." This not only contradicts the guidance provided in paragraph 2.10, but also may encourage tax authorities to request detailed profit data on all participants to the transaction even when the taxpayer's facts and business arrangements indicate that such profit information is not needed. In addition, paragraph 2.108, as currently worded, is very likely to be used by certain tax authorities to justify the use of profit split methods as the "most appropriate method" by considering certain functions performed in their jurisdiction as "unique".

KPMG also believes that the proposed guidelines should state that the tax authorities should not use net profit methods, and in particular the TNMM, to assert adjustments in the case of losses or high profits that result from business factors not related to transfer pricing. Use of the TNMM assumes that transfer prices have a significant impact upon profits, and therefore it is not appropriate for tax authorities to use the TNMM to force certain "arm's length" profit levels when intercompany transactions have only a limited impact upon profits (e.g., when a manufacturer purchases 10% of its inputs from an affiliate and 90% from third parties).

Comparability Factors

The Proposed Guidelines appear to suggest that each of the comparability factors has to be considered in all cases. However, depending upon the method used and data available, some of the comparability factors may simply not be relevant. For example, for transactions with readily available market benchmarks/world prices, including commodities, only two of the five comparability factors (characteristics of property and terms of contract) are relevant.

In this regard, three of the comparability factors are highly dependent upon contractual terms (product cycle, geographic markets, and business strategies of potential comparable companies). However, it can be very difficult to develop precise information about third party terms, particularly in the application of the TNMM, and KPMG is concerned that at least some tax authorities will interpret a taxpayer's inability to provide information about such terms about the majority of these

factors as evidence that "some pieces of information being missing" and conclude, per paragraph 1.38, that this is a flaw in the comparability analysis.

KPMG believes that it would be very helpful for the Proposed Guidelines to indicate explicitly that the analysis should focus only on relevant comparability factors, and should state that while the Proposed Guidelines provide suggestions and broad principles, they are not intended to provide prescriptive rules that must be applied in every case. This could be done by strengthening the helpful guidance given in Paragraph 1.37, which acknowledges that the extent to which comparability factors are relevant depends upon circumstances, by adding some additional examples.

Taxpayers Should Be Allowed To Rely Upon Data That Are Available to Them at the Time That They Evaluate the Transactions

Unrelated third parties make pricing decisions based on information that is available to them at the time of the transaction, so it is fundamentally unfair to hold taxpayers accountable for information that is not available when the taxpayer makes the decision. Moreover, taxpayers must accommodate the expectations of all tax authorities within the jurisdictions in which they operate and need the ability to finalize their financial records on a timely basis. Therefore, the Proposed Guidelines should state clearly that taxpayers are entitled to rely upon information that is available to them at the time that they evaluate the arm's length nature of their transfer prices, which could be:

- At the time transfer prices are set, if the taxpayer is focused on setting prices up front in an arm's length manner (which is often necessary depending upon the upfront allocation of risk and/or to facilitate compliance with customs and/or other direct tax requirements);
- At the time that the taxpayer closes its financial records, if the taxpayer wants to test prices *ex post,* but to reflect any required adjustments in its financial records;
- At the time that the taxpayer files its tax return, if the taxpayer is testing actual results immediately prior to filing its tax return. (As a general matter, this may have to be done at the *earliest* of the filing dates of the various tax jurisdictions affected by the transaction.)

In this regard, the Proposed Guidelines at paragraph 3.35 suggest that tax authorities could use secret comparables as long as they disclose the information to the taxpayer. As mentioned above, while it is obviously unfair for the tax authority to make adjustments based on information that is not available to the taxpayer, the second key problem with secret comparables is that the information is not available to the taxpayer at the time the transaction took place or even at the time that the taxpayer filed its tax return. A further complication relates to the confidentiality of such information: some tax authorities use information gathered from competitors as secret comparables.

As such, the use of secret comparables puts various firms at risk of having to disclose confidential information and trade secrets to tax authorities as part of a tax audit and only to see such information then used by this tax authority to make adjustments against one of its competitors. A firm reconfirmation not to use hindsight or secret comparables would be appropriate.

Need to Identify the Counterparty When Applying the TNMM

Paragraph 2.109 notes that there is often some uncertainty as to the counterparty in applying the TNMM. A sentence should be added stating that it is important that tax authorities resolve such uncertainties in carrying out their evaluation of a taxpayer's transfer pricing – in the situation in which there are multiple counterparties, the TNMM must be paired with additional information that allows a reasonable attribution of the results to the individual related party transactions. Failure to identify the specific counterparty when transfer pricing adjustments are made leaves the taxpayer effectively without access to Competent Authority or Treaty Protection.

Compliance Burden

While the Proposed Guidelines indicate that there is a need to balance the compliance burden with the magnitude and importance of the transaction, as a practical matter there are areas where the more specific guidance seems to increase the burden placed on taxpayers. Specific examples:

- Regional searches appear to be allowed, but with qualifications. Specifically, Paragraph 1.57 states that "[w]hile non-domestic comparables might be acceptable where they satisfy the requirements described in paragraph 3.34, this should not be interpreted as permitting the systematic use of regional searches for comparables for all the subsidiaries of an MNE group operating in a given region of the world, without proper regard being given to the particular circumstances in which each of these subsidiaries operates." This wording should be changed to something like: "Non-domestic comparables should be acceptable where they satisfy the requirements described in paragraph 3.34 unless there is a specific reason to believe that the reliability of non-domestic comparables is lower than that of other comparables." While geographic or country differences can raise comparability issues that need to be addressed under various circumstances, comparable data are difficult and expensive to find, and arbitrarily rejecting the consideration of comparables based on one particular attribute (e.g., country) often means that comparables that are more similar in other dimensions (e.g., with respect to functions, industry, size[2]) are excluded without any consideration of the relative importance of country specificity *versus* these other attributes. Moreover, taxpayers often have a

[2] As a specific example, when coupled with the independence screens that are generally used, requiring local comparables may mean that a taxpayer with 100 million Euros in sales may be tested using comparables that are all under 2 million Euros in sales.

practical reason for following a common approach across multiple geographies (which is also often observed in third party arrangements). While it is appropriate for tax authorities to expect taxpayers to use reliable and transparent data, it is not appropriate for the OECD to impose artificial limits upon taxpayers that often have the effect of both reducing the quality of the third party data used while simultaneously increasing the costs of compliance.

- Expensive data analysis: The Proposed Guidelines suggest some types of data analyses that can often be very expensive and which are not necessarily practical. This includes the segmentation discussed in paragraphs 2.119 and 2.131, and the suggestion in paragraph 2.138 that taxpayers may have to perform a valuation of their assets if they want to use an asset-based PLI. All of these suggestions should be accompanied by an explicit statement that taxpayers can limit their analysis to a reasonable level of effort, taking into account the size of the transaction and the likely impact of the "improvements" to the data on the reliability of the analysis. For example, a *de minimis* standard may be appropriate in paragraphs 2.119 and 2.131; paragraph 2.138 should note that it does not make sense to revalue tested party assets unless the assets of the comparables can be similarly re-valued, which is rarely possible with any level of precision.
- Qualitative information on the non-tested party: Paragraph 3.20 indicates that tax authorities may need qualitative information on the non-tested party. While it is true that tax authorities need sufficient information to validate the selection of the method, KPMG's experience has been that tax authorities often request much more data than is needed or reasonable. More guidance on the types of information needed would be helpful.
- Coordination with Customs and other Direct Taxes: Paragraph 1.77 essentially states that customs valuations may not align with valuations for income statement purposes, but that they "may be useful". Customs valuations generally are to be derived from prices that are "not affected" by the related party relationship (e.g., which are arm's length). While there are clearly different regulatory regimes in place for customs and transfer pricing for income tax purposes, tax authorities should allow taxpayers to coordinate their compliance efforts under the two regimes to the extent possible. The specific wording of this paragraph also appears to suggest that tax authorities and customs officials may benefit from sharing information (e.g., increase the likelihood of adjustments) without also suggesting that they should support taxpayer efforts to be consistent with and to comply with both regulatory regimes.
- While paragraph 3.80 is welcome in that it indicates that no exhaustive search for comparables is needed, it does not indicate that less effort should be required for minor

transactions. Similarly, while paragraph 3.81 talks about pragmatism and cost efficiency, it also suggests that certain comparables need to be updated annually.

Commensurate with Income

In paragraph 3.72, the Proposed Guidelines suggest that if there is a substantial amount of uncertainty, it may be appropriate for tax authorities to assume that arm's length parties would have inserted adjustment clauses in their pricing contracts. As a practical matter, parties at arm's length manage uncertainty in a wide variety of different ways. Adjustment clauses, milestone payment, and other contingency arrangements are some examples. Alternatively, taxpayers may simply adjust the prices set in the current transaction to reflect the level of uncertainty (risk) associated with the forecasts or expected benefits. Finally, it is inherently impossible to develop even imprecise definitions of "sufficiently uncertain" that will provide a common understanding of the term to both taxpayers and multiple different tax authorities. Suggesting that pricing adjustment clauses are the "normal" way of dealing with this issue is likely to increase the likelihood of adjustments. Even more importantly, it is likely to increase the exposure of taxpayers to double tax, in that the two tax authorities evaluating the transaction are likely to have different views of whether an adjustment would or would not have been needed at arm's length. This issue is best addressed through the requirement for clarity in the allocation of risk and approach to pricing that is used by the taxpayer.[3]

In some jurisdictions, one cannot simply disregard the rights and obligations of the parties even if one believes that economic theory or "economic reality" would require the inclusion of a price adjustment mechanism where none was intended by the parties. A price adjustment clause could be seen as a change in substance of the original agreement and as a change in the rights and obligations of the parties and, therefore, as such, could not be affected in these jurisdictions without invoking the power of recharacterization (and meeting the criteria necessary for such recharacterization).

Profit Splits

The scope for applying a profit split as set forth in paragraph 2.63 appears to be unduly narrow and downplays the role of risk. Parties operating at arm's length often enter into agreements (joint ventures, partnerships) that share risks with or without valuable intangibles. Paragraph 2.63 should be amended to allow for this.

KPMG is also somewhat concerned that the discussion of how to determine the basis of the profit split is unclear and may create confusion in some cases. It may be useful to add language that

[3] In this regard, the OECD's recent draft on Business Restructuring appears to acknowledge that taxpayers have considerable flexibility in setting up their intercompany arrangements, stating at paragraph 27 that: ""Just because a related party arrangement is one not seen between independent parties should not of itself mean the arrangement is non-arm's length"

acknowledges the difficulty in getting precise data, and which gives taxpayers the flexibility to use different approaches as long as they are reasonable. The discussion of cost based allocation keys in paragraph 2.91, in particular, is confusing, and it may be useful to indicate that the cost bases that are used in the allocation may have to be adjusted for differences in risks. It may therefore be useful to add language as can be found in paragraph 2.127 ("Such indicator might need to be adjusted depending on what party to the controlled transaction bears that risk, as well as on the degree of differences in risk").

Paragraph 2.79 correctly notes that a common base for financial statements is needed to apply a profit split analysis. This is an important point, and should not conflict with local rules since the pricing that comes out of the profit split can then be converted to local GAAP. It would be useful to add another statement indicating that taxpayers applying a common transfer pricing policy to multiple affiliates should be allowed to use a common accounting standard, particularly if they are using regional comparables.

Paragraph 2.99 establishes that a profit split that equalizes the rates of return of the participants may be appropriate. But it then goes on to state that it would not be appropriate if each of the participant's capital had a different level of risk (which is technically correct but does not acknowledge that there are well recognized methods for adjusting for ex ante differences in risk), concluding that it should be "used with great care" and that "other profit split methods should be considered before electing its use." This discussion reverts to the "method of last resort" standard that was applied to the TNMM in the current Guidelines, and may be used by certain tax authorities to reject an approach that is workable and appropriate in certain cases, and which in fact has been accepted by a number of tax authorities in the past. While there are certainly other ways of implementing a profit split analysis, taxpayers should be allowed to use an appropriate method for allocating profits, and the Proposed Guidelines should not impose *a priori* judgments based on assumed facts.

Determination of Net Profits

Paragraph 2.121 of the Proposed Guidelines states that EBIT is "…one of the most commonly used measures of net profit." Even if true, this statement may mislead at least some tax authorities to interpret it as saying EBIT is the *only* reasonable measure of profits. We would suggest that the Guidelines say instead that taxpayers should use whatever measure of net profits provides the most accurate "yardstick" for comparing the financial results of the tested party with those of the comparables. The exact definition of this measure may vary on a case by case basis, or even with the particular local GAAP that is used. For example, some definitions of EBIT may include depreciation expenses associated with local restructuring even though these have nothing to do with transfer pricing. In other cases, certain types of expenses may have an impact upon EBIT but are unlikely to reflect costs that determine prices (e.g., pension charges associated with "truing up" pension assets needed to cover pension obligations that were incurred in prior years). A cross reference to paragraph 2.125 would be helpful.

KPMG is concerned that the guidance provided in paragraph 2.126 will encourage tax authorities to selectively take the position that start-up costs and shut down costs have to be marked up and charged out/incorporated in the determination of profits because they are for the "benefit" of the other party. In reality, companies at arm's length do incur and retain start-up costs based on the expectation (but not the guarantee) that these costs will be recovered in future years. Similarly, companies at arm's length are forced to bear shut down costs when customers either lower their purchases or terminate a business relationship. While paragraph 1.126 does acknowledge that the treatment of startup and termination costs should depend "on whether, in comparable circumstances, independent parties at arm's length would have agreed ….", KPMG believes that this point should be strengthened by explicitly stating that the "benefits" of a start-up expense may be expected profits in future years, and that the overriding principle (regardless of the method used) is whether or not such cost would have been charged out at arm's length

Choice of PLIs

While it is useful to have more PLIs explicitly endorsed than in the current Guidelines (including Berry ratios), it is not self-evident that one PLI might be more appropriate than another. Moreover, the focus on risk in paragraph 2.127 is of some concern, as it is unclear what the "significant risk due to the significance of the investments" might be where operational risks are limited. (If there is a manufacturing service fee which covers the cost of investment, then the investment risk is reduced.) A return on capital is a different measure than cost-plus, and the two ratios measure different things and have different attributes. The choice between them depends upon a wide variety of factors (e.g., the ability to measure the denominator accurately) other than just risk.

The Proposed Guidelines should make it clear that taxpayer should have the ability to use the PLI that is most appropriate for the specific circumstances. Much the same principle should apply to PLIs as is intended to apply to methods: taxpayers do not have to prove or disprove application of the PLI.

Adjustments to Comparables

The Proposed Guidelines take a very cautious approach to adjustments, and seem to be skeptical of them generally. For example, the discussion of working capital adjustments in paragraphs 3.38 and 3.52 seems to discourage the use of such adjustments. While there should be no presumption that adjustments are always needed or will always improve comparability, there should be recognition of the fact that when properly used adjustments can:

- increase the pool of potential comparables (e.g., allow buy-sell distributors to be used as comparables to commission agents);

- allow more flexibility in the use of specific PLIs (e.g., by allowing income or cost based PLIs to be used even when there are significant differences in assets as a percent of sales or costs);
- improve comparability for companies using different GAAPs (by adjusting for items that are treated in different ways); and
- illustrate the impact of economic conditions upon the tested party's results (e.g., by showing the impact of operating at 90% rather than 50% capacity utilization).

The key issue is the objective question of whether making comparability adjustments allows for a more accurate analysis. This is certainly not always true, but it is sometime true and taxpayers and tax authorities should not be discouraged from using comparability adjustments when they improve the analysis.

Miscellaneous Comments

Paragraph 1.9: What is the definition of a "specialized service"? KPMG is concerned that by mentioning "provision of specialized services" in the same sentence as "integrated production" and "unique intangibles", certain tax authorities will use this paragraph to argue that a profit split is the (most) appropriate method, thus resulting in obvious double taxation risk.

Paragraph 1.39: A typing error slipped in the third sentence: "Characteristics that [it] may be important to consider include the following".

Paragraph 1.48: KPMG suggests adding "regularly" in the last sentence of this paragraph. We are concerned that this paragraph, as drafted, could be interpreted to mean that adjustments to reflect exchange rate movements are never permissible in the stated circumstances. Third parties do renegotiate prices when exchange rate movements are significant and persist for an extended period of time. Therefore, KPMG suggests that the sentence be amended to read "If, for example, a manufacturer sells property to a related distributor in another country and the taxpayer's documentation indicates that the distributor assumes all exchange risks, but the transfer price appears in fact to be *regularly* adjusted so as to insulate the distributor from the effects of exchange rate movements, then the tax administrations may wish to challenge the purported allocation of exchange rate risk."

Paragraph 2.3: While KPMG welcomes the broader acceptance of transactional profits methods and the removal of the TNMM from a method of last resort, KPMG is concerned that the wording of this paragraph may artificially discourage the use of resale price and gross cost plus approaches without consideration of the full functional and risk implications of the shift to a transactional profit method.. There is a different allocation of risk under a gross margin analysis than under a TNMM analysis, in that the former is less sensitive to the impact of changes in volume in relation to fixed

costs than the latter. Therefore, there may be cases in which it may be better to adjust for differences "which are reflected only in operating expenses" and use an adjusted gross margin rather than go directly to a TNMM. In practice, the current wording of this paragraph is used by certain tax authorities to reject the use of the resale price method on the basis that the operating expenses of the comparables (potentially divided by sales) are different from the operating expenses of the tested party (potentially divided by sales). However, even under these circumstances the resale price method or transactional cost plus method may lead to a more arm's length allocation of risk.

Paragraph 2.100: It would be useful to cross reference additional guidance on the use of "internal comparables" (e.g., paragraphs 3.25 to 3.29).

Paragraph 2.101 and 2.102: The concept of "unique" and 'routine" intangibles is relatively vague, with no explicit definition. Moreover, the key question of whether or not a TNMM can be used is not so much a question of whether the tested party has a "unique" intangible as one of whether reliable benchmarks can be found (e.g., is it possible to either find comparables with similar intangibles and/or to value the intangible separately based on third party pricing data). KPMG is concerned that the wording used in these paragraphs will allow certain tax authorities to reject the use of the TNMM whenever there are any separately identified intangibles.

Paragraph 2.120: We would recommend modifying the last sentence as follows: "Even where exceptional and extraordinary items are not taken into account in the determination of the net margin, it [may] be useful to review them because …."

Paragraph 2.152: For the avoidance of doubt, KPMG would recommend adding a reference to paragraph 2.10 to the first sentence: "In all cases, caution must be used to determine whether a transactional profit method as applied to a particular aspect of a case can produce an arm's length answer, either in conjunction with a traditional transaction method or on its own, with due regard to paragraph 2.10".

Paragraph 3.2: It may be useful to add a cross reference to paragraph 1.7 at the end of the second sentence. This sentence would then read: "This does not mean that there is a requirement for an exhaustive search of all possible sources of comparables as it is acknowledged that there are limitation in availability of information and that searches for comparables data can be burdensome (see also paragraph 1.7)"

Paragraph 3.3: While KPMG understands that tax authorities do not have to agree with the taxpayer even if the taxpayer makes a "reasonable effort," it would be useful to add that taxpayers should get some benefit as a result of making such an effort -- e.g., relief from penalties, no shifting of burden of proof.

Paragraph 3.5: The fifth step appears to require the taxpayer to audit third party databases for reliability ("determination…of the sources' reliability"). KPMG notes that the French version of the

Proposed Guidelines differs from the English version on this point and we would recommend aligning the English version to the French version in modifying Step 5 as follows: "Identification of available sources of information on external comparables where such external comparables are needed and an appreciation of the sources' reliability."

Paragraph 3.5: The last of the steps discussed is purely procedural and does not relate to the search process *per se*. Therefore, it has no bearing on whether the results of the search are arm's length or whether the range is appropriate, and probably should be in a separate paragraph.

Paragraph 3.10: The current wording may lead taxpayers and tax authorities alike to conclude that analyzing a combined transaction is only possible for (tangible) products. To avoid this potential misunderstanding, we would recommend changing the third sentence as follows: "For instance, some products may be marketed by a taxpayer with a low profit or even at a loss, because they create a demand for other products [and/or related services] of the same taxpayer that are then sold with high profits…."

Paragraph 3.14: The use of the word "accurately" appears to indicate that perfection, which can in practice never be attained, is needed when quantifying a set-off. We would recommend changing to "sufficiently accurately" to avoid this potential misinterpretation by taxpayers and tax authorities alike. In addition, KPMG believes that the following sentence should be added to the end of the paragraph: "Having said this, taxpayers can also support such a set-off by showing that unrelated third parties in fact do enter into such set-off arrangements." While the OECD may believe that this is unlikely, such set-off arrangement can and do occur, particularly in the form of cross licensing arrangements.

Paragraph 3.15: The very end of this paragraph, "at the time of filing the tax return", unduly imposes a contemporaneous requirement. KPMG therefore suggests deleting these words, which would fix the issue but still retain the instruction and meaning of the entire paragraph. In addition, the paragraph should explicitly allow taxpayers to raise set-off arguments in situations in which tax authorities use a different method or apply the same method to a different aggregation of transactions than the taxpayer. For example, if the taxpayer bundles two transactions, a set-off may not be necessary. However, if the tax authority segregates the two transactions and proposes an adjustment to one, a set-off argument may very well be justified.

Paragraph 3.30: KPMG sees considerable risk in including the sentence "It is not always the case that commercial databases provide the information that is detailed enough to support the chosen transfer pricing method". While the quality and detail of data are important factors in the selection and application of a method, it is very easy to point to data issues and use these issues as a means for eliminating consideration of certain methods. We have already seen several instances where certain tax authorities refuse the use of traditional transaction methods on the basis that insufficient information is available in the public domain to reliably use these methods. This sentence would

therefore likely be used by these tax authorities to provide an authoritative voice, i.e. the voice of the OECD, as support for this position.

Paragraph 3.37: As stated during the Public Consultation Sessions by members of the OECD's Working Party 6 and taxpayers alike: the perfect (external) comparable does not exist. To recognize this fact, we would recommend changing "not always" in the first sentence to "seldom".

Paragraph 3.40: This paragraph allows for the use of an "additive approach" in which the person conducting the search for comparables develops the set of comparables by including companies that he/she believes are potentially comparable. While this approach has advantages in terms of efficiency and cost, it is also vulnerable to "cherry picking" selected comparables and may also allow certain tax authorities to include comparables that are not known to the taxpayer at the time that they evaluated their transfer pricing. While the paragraph does state that "… the process followed be transparent, systematic, and repeatable,....", KPMG believes that it is important to stress not just the need for transparency, but also the need to rely upon data that are reasonably known and available to taxpayers at the time that they evaluate their transfer pricing.

Paragraph 3.42: KPMG is concerned about the current wording regarding the size criteria. It should be recognized the many multinational enterprises, by their very nature, are bigger than most if not all of the independent companies one may find in external databases. The sentence "Size criteria in terms of Sales, Assets or Number of Employees" does not introduce the notion of relativity, although this is done in the second sentence ("or in proportion to the activities…"). We ask the OECD to reconsider the wording of this first sentence of the first bullet point in the light of the fact that certain tax authorities will use this sentence to argue that no comparables exist for the related entity in their jurisdiction. More generally, size or any other screen that has the effect of excluding comparables should only be used if there is objective evidence that the screening criteria are something that should affect the analysis.

Paragraph 3.49: There appears to be a typing error that crept into the second sentence. We would recommend rephrasing to "Factors to be considered include: the quality of the data being adjusted, the purpose of the adjustment performed and the reliability of the adjustment".

Paragraph 3.56: While the use of a range is one way of increasing precision given the inherent limitations of some types of data on comparables, the use of the range is in itself an admission that the comparables' data are not perfect. Therefore, the application of any arbitrarily defined range is likely to exclude results that are in fact arm's length -- by definition, fully 50% of the data points that are determined as "comparable" are excluded under the interquartile range definition. Therefore, the range concept should not be applied in a way that limits taxpayer's ability to show that results that are outside of the range are in fact arm's length, or to have very minor differences lead to substantial adjustments. For example, assume that the taxpayer has identified a set of comparables with an interquartile range of 2% to 5%, with a median of 3.5%. If the inclusion or

exclusion of a comparable pushes up the lower boundary from 2% to 2.1% (or pushes down the upper boundary from 5% to 4.9%), and as a result the tested party falls outside of the range, this minor change should not be the basis from an adjustment to the median. Allowing for such minor changes to generate large proposed adjustments not only increases the likelihood of disputes between taxpayers and tax authorities, but also makes it much harder for the two different tax authorities to come to agreement and to provide double tax relief.

Finally, KPMG is concerned that different tax authorities will implement the range concept in inconsistent ways – some stating that the full range is appropriate, others focusing on the interquartile range, others focusing on some other measure (e.g., the average plus or minus some amount). The Proposed Guidelines should discourage tax authorities from being overly prescriptive, and should defer to the measure of range proposed by the taxpayer as long as such measures are reasonable under the facts and circumstances in question.

Paragraph 3.61: While the wording is not clear, it could be read to suggest that when adjustments are made, they should be made to the median of the range. This is not consistent with current practice in many countries, and is a dangerous simplification since the median of the range may be sensitive to the inclusion or exclusion of a given specific comparable. The wording should be clarified to indicate that the adjustment should be limited to the lowest number needed to reach an arm's length result.

Paragraph 3.69: Similar to our comments above, this paragraph may lead tax authorities to conclude that year-end compensating adjustments are required as soon as results fall outside a range. We would therefore recommend adding the following sentence at the end of this paragraph: "It should be noted that this practice (of year-end adjustments) also depends on the method that is applied by the taxpayer, which in turn depend on, amongst others, its functional profile. Taxpayers can fall outside of a range due to the outcome of risk, economic circumstances, or other factors not related to transfer pricing. ".

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