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Comparability: OECD invitation to comment on a series of draft issues notes

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The OECD has requested comments on the issues notes covering comparability issues. This submission provides comments by KPMG’s Global Transfer Pricing Services group on some of the comparability issues put forward for consultation by the OECD.

Timing issues in comparability

The OECD Guidelines are in favour of taxpayers endeavouring to establish that their transfer pricing methods are appropriate before they set their prices, as set out for example in paragraph 5.3 of the Guidelines. However, taxpayers should also be permitted to use any suitable method to demonstrate subsequently that their prices are at arms length, and this may be a different approach to the method used to set prices. For example, a transactional profit method might be used by the taxpayer to demonstrate that prices were originally set according to the arms length principle, or to test that the profits resulting from their transfer prices are consistent with the arms length results originally expected.

We therefore agree with the statement in paragraph 10 of the issues note that “a taxpayer may try 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. In other cases, a comparability study may be carried out to verify the consistency with the arm’s length principle of prices actually charged for transactions already completed. Such an ex post facto verification may take place when the year-end tax return is filed and/or at a later stage in the course of an audit by the tax authorities.”

Tax administrations should not draw any adverse conclusions where the taxpayer presents transfer pricing documentation demonstrating that the prices are at arms length using methods that were not necessarily those used at the time of the original price-setting.

In summary, taxpayers should retain the right to set prices using whatever method is effective from their own practical point of view, and to be able to check and defend their intercompany prices at a later date by an alternative approach. This point was also made in our response to the OECD consultation on transactional profit methods.

Timing of collection of information

One of the main concerns with regard to the timing of information collected from the taxpayer is the compliance costs that result from the different requirements in different countries – the inconsistency of rules from one country to another produces a compliance burden. There is always a balancing exercise between provision of adequate data and the resulting compliance costs.

The division of the life of an ongoing business into tax years is inevitably artificial and arbitrary. The division between one tax year and another should not place a limit on the ability of taxpayers to identify and use appropriate comparables. We would therefore agree with the statement in paragraph 32 that “while *contemporaneous* means during the same period of time, it does not necessarily mean during the same tax year”.

Use of data from years subsequent to the year of the transaction

On the use of data from years subsequent to the year of the transaction, this data can be useful as currently stated in the Guidelines for comparing product life cycles so as to evaluate the level of comparability between products. However data from subsequent years cannot be used to overturn the allocation of risk established by the taxpayer at the time of the original transaction. For this reason, the Guidelines should not endorse any attempt by tax administrations to use hindsight to challenge prices set at arms length at the time of the original transaction. We note that the Guidelines currently state that “care must be taken by tax administrations to avoid the use of hindsight” (paragraph 1.51) and that further work may be done by the Working Party on this issue.

What we would like to emphasise is that the allocation of risk at the time of the transaction cannot be overturned simply on the basis of the level of subsequent profits, without further evidence to suggest that the original allocation of risk was unsatisfactory.

Please see also the points made in the discussion of multiple year data below.

Determination of available sources of information and their comparability

We agree with the statement in paragraph 4 of this issues note that “even information that may not directly relate to the transaction may provide valuable insights into the workings of the transaction with respect to the relative value of functions and attribution of risks between arms length parties engaged in comparable transactions”. Information about a third party licensing agreement, even if that agreement cannot be used to establish pricing because of differences in

products/technology covered, can still give useful insights as to the ownership of intellectual property and the typical terms of a contract. For example licensing agreements concerning trademarks are very specific about ownership of the trademark at the end of the license.

Use of secret comparables

Regarding the use of secret comparables as discussed in paragraph 11 onward, we take the view that tax authorities should never use secret comparables. From a business point of view, taxpayers are in the best position to understand whether a third party transaction is or is not comparable. However in the case of secret comparables it is impossible for the taxpayer to evaluate whether the terms of the third party agreement are sufficiently similar to make it a reliable comparable or whether adjustments have to be done.

We take the same view of the use of secret comparables in mutual agreement procedures, where the tax authority could overlook a critical factor affecting pricing and the taxpayer may not have an opportunity to point this out to them.

Use of public databases

The tax authorities should not require the use of particular public databases or suggest that they favour the use of any particular database. To do this is to effectively give an official endorsement of that database and this can create a disadvantage for taxpayers who may not have access to the database concerned or who may not use it sufficiently often to have acquired familiarity with it. The taxpayer should be free to use a database that the particular taxpayer is comfortable with.

The EU Joint Transfer Pricing Forum has commented on the issue of the use of pan-European databases, an issue which could be more generally discussed as the use of non-domestic, regional databases. The problem for multinational groups is that if they must look for domestic comparables in each of the countries in which they are doing business, the compliance costs involved with the search are likely to increase with the number of countries in which comparables must be found. Certainly in the case of the EU the differences between single-country comparables and pan-European comparables is unlikely to be statistically significant, and the Code of Conduct on EU Transfer Pricing Documentation contains a recommendation that pan-European databases should not be rejected automatically and that transfer pricing penalties should not be imposed only because the taxpayer has used pan-European comparables.

A statement in the OECD Guidelines to the effect that regional databases should not be rejected by tax authorities without supplying further evidence for their decision would be welcome.

With regard to other publicly available information, where there are commercial models that are used in price setting by unrelated parties taxpayers should be able to use those models to derive transfer prices.

Uncontrolled transactions

Possible use of consolidated data

In paragraphs 18 and 19 of this issues note, the possible use of consolidated data is mentioned. We wish to emphasise that the most reliable data should always be used, and sometimes this may be consolidated data. The criterion for selecting data to be used should not be whether or not it is consolidated data but whether it is the most reliable and suitable in the particular case.

For this reason the Guidelines should not reject the use of consolidated data. Taxpayers should be given an opportunity to explain to the tax administration why the use of consolidated data might be appropriate in the facts and circumstances of a particular case.

Examining the five comparability factors

Generally in examining the five comparability factors, the Guidelines should not attempt to prescribe in any rigid fashion the ways in which these factors are used in practice or the relative importance that should be attached to any particular comparability factor. The significance of the comparability factors and the relevance of each factor in any particular case may depend on the facts of that particular case. Tax authorities have to recognize practicalities and cannot be too prescriptive in the application of these factors in any particular case.

Contractual terms

Contractual terms between related parties should be respected by the tax authorities where they are commercially reasonable and where the terms of the contract are actually followed in practice. A contract between related parties has importance from a transfer pricing perspective in that it shows to the tax authorities the intentions of the related parties from the beginning of the contract. Therefore, even if the tax authorities determine that a pricing adjustment is appropriate, they should not change the form of the transaction.

Economic circumstances

In the discussion of economic circumstances there is a mention of size criteria in terms of sales, assets or employee numbers. We would not however wish to see any rigid statement in the Guidelines to the effect that size criteria are always significant, as this is another factor whose importance depends on the particular circumstances of each case. In practical situations, a set of comparables may vary greatly in size and the question of whether a particular third party is comparable may not be affected by the criterion of size.

Determination of and making comparability adjustments where appropriate

We would agree with the statement in paragraph 19 with regard to balance sheet or asset intensity adjustments that “the fact that such adjustments are found in practice does not mean

that they should be performed on a routine or mandatory basis". The Guidelines should not suggest that working capital adjustments should be made as a routine matter. Where such an adjustment is made it should be clearly shown why the adjustment is improving comparability in that particular case.

In this as in other cases, the particular facts and circumstances of the case must be the basis of any adjustment. A working capital adjustment must be accompanied by an explanation of why, given the circumstances of that particular transaction, making the adjustment improves comparability.

Multiple year data

The question of whether transfer pricing adjustments should be determined on a year by year basis or over a period of time, as considered in paragraph 17, is more complex than suggested by the issues note. In a situation where transfer prices are below arms length for one year and above arms length for another year, the OECD Guidelines should discourage any year by year cherrypicking by tax authorities where the overall result over the whole period is at arms length or can be adjusted in the second year.

Also, where the related parties have made a contract for a particular price over two years that was consistent with comparable third party transactions at the time the contract was signed, no adjustment should be made on a year by year basis.

We can consider a situation where the arms length price is 100 in year one and year two, but the related party price is 90 in year one (understated) and 110 in year two (overstated), but because sales in both years are the same the average price is 100 for the two years. If the tax authorities can cherrypick in this situation, tax authority A will increase the understated price in year one to 100 while not amending the price in year two, and tax authority B will not adjust in year one but will amend the price in year two to 100.

The result therefore is that from the perspective of Country A the average price over the two year period is 105 (5 above the arms length price) and from the perspective of Country B the average price over two years is 95 (5 below the arms length price). This kind of cherrypicking by the tax authorities does not therefore lead to a logical result. If the taxpayer were to apply for relief under the mutual agreement procedure, the logical outcome of the procedure would be to agree an average price of 100 over the two year period.

One might also consider a different scenario where the controlled party enters into a two year pricing contract where the price is set at 100 and fixed for two years. This contract is consistent with a comparable transaction with a similar two year term that takes place at the beginning of year one. In year one, the average spot price is 90. In year two, the average spot price is 110. In this case, the transfer pricing is correct in both years even though it is higher than the spot price in year one and lower than the spot price in year two. The tax authorities should not make a transfer pricing adjustment under these circumstances.

The use of multi-year averaging is important to take into account the business lifecycle of a business, as otherwise comparable companies may experience a downturn at a different time to the controlled company. The use of averaging over a number of years can mitigate the differences in the outcome of the risks realized by the controlled entity and the comparable companies. This increases the number of possible comparables that can be used. Even with the use of multi-year averaging however there is still a need for the specific evaluation of unusual risk.

Aggregation of transactions

We do not agree that it is necessarily true that aggregating third party transactions generally lowers comparability. A business may determine that a particular product among a group of related products serves as a loss leader in a particular period, and the product chosen as a loss leader may be changed from time to time, but remaining within a group of related products and keeping the margin earned by that group of products the same. In this situation, to examine the price of each product separately would reveal variations in margin between periods while examining the group of products in aggregate would show a consistent margin, and the aggregation of the products would therefore provide a much more reliable measure than the individual product data.

For example, in the case of a grocery store selling fruit, Store A may decide on apples as the loss leader to attract customers into the store, with bananas, grapes and oranges priced to generate an overall profit margin of X percent. In February, Store A may choose oranges as the loss leader with the remaining fruit including apples priced so as to obtain the overall margin of X percent. For Store B, grapes may be the January loss leader with the price of other fruit set to obtain the overall margin of X percent, while in February bananas would become the loss leader. These two grocery stores are clearly pricing so as to receive an overall margin of X percent but they do this with margins on individual products that vary somewhat arbitrarily depending on what fruit is chosen to feature as the loss leader in each month. In this situation, as a practical matter the aggregated data may provide a much more reliable measure than the data on any individual product.

Generally aggregation of products should be considered based on the economics of the particular situation. Where the price of one product depends on the price of another, considering the two products in aggregate may lead to a more accurate result than looking at either product on a stand alone basis.

There may also be cases where goods are bundled with certain services and the two are so closely linked that the pricing of either the goods or the services separately would not lead to a realistic result. Again, the decision on whether or not to aggregate depends on the facts and circumstances of the particular case.

The Code of Conduct on transfer pricing documentation for associated enterprises in the European Union refers to the possibility of aggregating transactions in the following passage (in Section 2 of the Annex):

“The aggregation of transactions must be applied consistently, be transparent to the tax administration and be in accordance with paragraph 1.42 of the OECD Transfer Pricing Guidelines (which allow aggregation of transactions that are so closely linked or continuous that they cannot be evaluated adequately on a separate basis). These rules should be applied in a reasonable manner, taking into account in particular the number and complexity of the transactions.”

The taxpayer should have the opportunity to explain to the tax administration why in the facts and circumstances of the particular case the aggregation of transactions is appropriate.

Definition of the arms length range, extreme results, methods to enhance reliability, loss-making comparables

Loss making comparables

With regard to loss-making comparables, we wish to emphasize that companies that are bearing risk always have the possibility of losing money at arms length. Losses can arise for all kinds of reasons and as mentioned in paragraph 21 of the issues note “it is the facts and circumstances surrounding the company in question that should determine its status as a comparable, not its financial result”.

A company may make losses in the short term owing to a temporary downturn in trade or a particular business strategy, later turning this round into profits in later periods. Losses may also be more permanent and irreparable where a high-risk project fails. There may also be situations where a loss-making business continues trading for some time owing to the greater costs that would arise if it were to close down, for example costs arising from local labour protection laws.

To take on risk involves the possibility that losses may arise. When these risks materialise and result in losses, a business can be loss making in a year or over a number of years, even though the business is fundamentally sound and potentially profit-making. Transfer pricing disputes can arise on transactions between loss-making related parties, partly because the tax administrations do not always acknowledge this fundamental fact of doing business.

We therefore agree that there should not be a rule rejecting loss-making comparables and that the possibility of including such comparables should be acknowledged in the Guidelines. The reality of doing business should be acknowledged and especially the fact that taking on risk involves the possibility of incurring a loss.

With regard to distributors, there should be no suggestion in the Guidelines that distributors should always be profitable or that a profit should be earned following a certain number of years of losses. Taxpayers should be permitted to demonstrate the reasons why losses have arisen in the business and to demonstrate why despite the incurring of losses the transactions have been conducted at arms length.

Documenting a search for comparables

Tax administrations have the right to require taxpayers to document their search for comparables in a manner that can be understood and checked by the tax administration, and the necessary data should be provided to enable the tax administration to evaluate the position of the taxpayer. The documentation requirements should not however place an unnecessary compliance burden on the taxpayer especially in view of the fact that multinationals may be attempting to satisfy documentation requirements in a large number of jurisdictions.

Tax administrations should not therefore initially require information that is not relevant to evaluating the transactions, especially as it is always possible for them to ask further questions once the documentation has been examined. The tax administration can ask for further information where more detail is required to evaluate a complex or unusual situation. Where such information is asked for, the Guidelines could encourage the tax authorities to discuss with the taxpayer why detailed information has been requested and why the data requested is relevant to the enquiry. The taxpayer would then have the opportunity to point out any reasons why the data may not be relevant.

Individual countries should be discouraged from adopting their own narrowly defined practices while rejecting other approaches. Many multinationals have to document transactions in multiple jurisdictions and they would prefer to see the use of consistent criteria across the different jurisdictions, both for reasons of cost and efficiency and to enable them to give consistent information to different jurisdictions without having to adjust the information to conform to different requirements of the national tax laws. The need to adjust information to local requirements can give rise to apparent discrepancies in the information between one country and another which can lead to closer attention from tax authorities even though the apparent discrepancy results from inconsistent rules between different tax jurisdictions. It is also in the interests of the tax authorities themselves for taxpayers to provide consistent information to different tax authorities.

The Guidelines could take account of some of the conclusions of the EU Joint Transfer Pricing Forum in its Code of Conduct on EU Transfer Pricing Documentation. This takes the view that the main purpose of transfer pricing documentation is for risk assessment, as in the following statement in Section 1 of the Annex:

“The EU TPD should contain enough details to allow the tax administration to make a risk assessment for case selection purposes or at the beginning of a tax audit, ask relevant and

precise questions regarding the MNE's transfer pricing and assess the transfer prices of the inter-company transactions."

The main purpose of transfer pricing documentation on this view is not to enable the tax administration to obtain evidence to demonstrate that transfer prices are not at arms length, but to enable them to make a risk assessment following which they will ask for specific detailed information if necessary for them to examine particular complex or important transactions.

The EU JTPF also acknowledges that the transfer pricing documentation may not be the same as documentation produced by unrelated parties. The following statement is in Section 4 of the Annex:

"Documentation does not need to replicate the documentation that might be found in negotiations between enterprises acting at arm's length (for example, in agreeing to a borrowing facility or a large contract) as long as it includes adequate information to assess whether arm's length pricing has been applied."

The work of the EU JTPF could also be relevant to the question of the search for comparables. In particular, the JTPF was concerned with the compliance costs that could result from a search for comparables when there was a need to satisfy the transfer pricing rules of numerous jurisdictions.

As mentioned above, this kind of approach does not prevent the tax administration from asking for further detailed information in respect of complex and important transactions, but it would be useful if the tax administration was obliged to explain why the further information was needed and if the taxpayer was given the chance in turn to explain why it might not be relevant. Although the OECD Guidelines already refer to this problem in paragraph 5.6., it would be useful to have more detail in the Guidelines on this point and we agree with the suggestion that the taxpayer should have a chance to point out that the cost of locating the comparable data would be disproportionately high relative to the amounts at issue.

The level of documentation requested by the tax authorities should be related to the size of the transaction, in absolute terms and relative to the size of the taxpayer's business, and to the complex or unusual nature of the transaction on which more information is required

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