CONTRIBUTION RECEIVED FROM PRICEWATERHOUSECOOPERS

Issue: COMP 1 – Requirement to perform an analysis of* transactions *vs. an analysis of third party information gathered at a company level

<u>1 – Is it a real issue?</u>

Can third-party data at company level meet the arm's length standard and if so under what conditions and to what extent?

Yes, third-party data at a company level can be used to meet the arm's length standard, when the following conditions are met:

- There is no reliable, accurate, and, - if appropriate - adjustable third-party data available at a transactional level that can better meet the comparability factors specified in Chapter I, Part C of the Guidelines.

- The third-party companies meet the comparability criteria specified in Chapter I, Part C of the Guidelines (as stated specially in paragraphs 1.17 and 1.20; see also 1.30 and 1.31). Reference can be made to the comments in COMP 3 below.

- Reliable, accurate third-party company-level data is available and sound adjustments, if necessary, can be made. (In particular, accounting standards of the third-party's financial data and that of the business segment of the tested party under review should be similar.)

<u>2 - Is it an important issue?</u>

Yes, this is a real and important issue as the Guidelines place a strong emphasis on the application of methods using third-party transactional data. In this respect, paragraph 1.42 states that "ideally" the arm's length principle should be applied on a transaction-by-transaction basis to arrive at the fairest approximation of a fair market value. However, in reality it is only in limited circumstances that relevant information regarding sufficiently similar transactions can be found, and often there is no "precise market value" for such transactions. This renders the wording of paragraph 1.42 somewhat abstract.

One of the primary issues concerning the use of transactional information is the limited availability of relevant data in the public domain. With the best will in the world, a taxpayer can only use the evidence that is available to it. Where data is limited, taxpayers and tax authorities alike should make the best use of the evidence that is available. In the absence of internal comparables, it will only in rare circumstances be possible to obtain data on independent companies on a transactional level. Several reasons can be identified in this respect. In particular, a difficulty arises from the different requirements imposed by the respective OECD Member States on the disclosure of company data. In the United States, for example, companies are required to report transactions (i.e. agreements) where they are material to their business. This means that, on a global basis, there exist a wide variety of reporting requirements and formats, which often make it difficult for transfer pricing practitioners and taxpayers genuinely to compare results. One common denominator, however, is that, normally, financial information is published on a company rather than on a transactional level. Moreover, taxpayers can only rely on filings, commercial databases or the

Internet to obtain transfer pricing data. A significant drawback is that commercial databases are not originally set up for performing transfer pricing analyses.

Having said this, company-level data is often the most reliable and effective tool at the disposal of transfer pricing practitioners. Reference can be made in this respect to the comments raised on COMP 3 and COMP 6, dealing respectively with the 5 comparability factors and the use of commercial databases. Therefore, transfer pricing practice recognizes that the use of transactional data as put forward by the OECD is sometimes unattainable due to the unavailability of external transactional comparables. Indeed, multinational enterprises often engage in hundreds of thousands of individual transactions from a transfer pricing perspective, which may be difficult to isolate. It should, however, also be noted that the business community has developed acceptable ways to address the pitfall resulting from the absence of transaction based comparables without breaching the arm's length principle. This can best be illustrated by the following example: imagine a taxpayer with a complex functional and risk profile (involving production, distribution and services) with no internal comparables. In these circumstances it may be difficult to find comparables on a transactional basis. A transactional analysis may be approximated by segmenting the tested party's financial data by function and further, if possible, by product/service. Each segment, based on functions, can then be tested against third party company data performing similar functions. It is clear that, although this approach cannot be fully aligned with the current wording of the Guidelines, it is nevertheless consistent with the underlying spirit of the Guidelines, i.e. the arm's length principle. It also underpins the fact that, in practice, the adequacy of the available information is often assessed a posteriori, depending on the methods chosen.

3 - Experience with respect to this issue

For the vast majority of transfer pricing studies, third-party company-level data is used to determine the arm's length result. The extent to which this is feasible or appropriate will vary on a case-by-case basis. In general however, it is applicable both for compliance purposes and in cases where the documentation is created in the context of a dispute or APA negotiation.

Nevertheless, tax authorities sometimes question this approach or simply reject a comparability study, thereby placing a heavy burden on the taxpayer to justify why he did not prepare documentation on a transactional level. More often than not, this burden is unreasonable as the ideal world is not attainable in practice and the taxpayer may often have used all possible reasonable efforts to comply with the arm's length principle and any documentation requirements.

Alternatively, in some situations tax authorities will move straight to a profit approach ignoring transactional data and proposing significant tax adjustments on that basis.

Finally, on some occasions, tax authorities have sought to rely on 'geographical or segmented' data as disclosed in audited statutory accounts as comparables to benchmark a taxpayer's results. In our experience there are considerable problems with using such information and we would argue that segmented data should be used only with caution. For example, the segmented results may incorporate less than rigorous allocations of central income and expenses across segments. Further, it may be difficult to separate segments of a company which are intrinsically linked. Also, as companies restructure their operations, there may be issues with the availability of data over a period of time (for example, while a business may be classified in one segment of the company in one year, it may, due to restructuring, be classified in another the following year).

4 - Suggestions for improving the existing guidance in the Guidelines with respect to this issue

One way to improve the Guidelines with respect to this issue would be to include in Chapter I, Part C, under "Guidance for applying the arm's length principle", a new section relating to the quality and reliability of the available third-party data. This section should emphasize the fact that the reliability, accuracy and completeness of the third-party data and the guidance as to how and when to use segmented data will largely influence how compliance with the arm's length principle is assured, and that a taxpayer that has made a good-faith effort to consider the data available and uses it as well as possible in the circumstances, should not suffer as a result.

The OECD could for instance provide explicit support for an approach to separating the different functions of a tested party-company in a building block model. Instead of trying to compare two companies, the different functions should be separated e.g. production, sales, service and R&D. Each of these functions should be benchmarked against comparable uncontrolled entities that are merely engaged in a specific activity. This gives a much better picture than making comparisons at a broader company level. Moreover, consideration could be given for safe harbours to cover situations with very little risk. Examples are distributors or commission agents for sales of the products of parent companies.

Guidance should be provided as to when a transactional method should be used and the circumstances in which an entity-wide approach should be taken. Presumably the factors to be considered should include the directness of comparability required and the availability and reliability of the data.

Issue: COMP 2 - Need to rely on transactions that took place between independent enterprises

<u>1- Is it a real issue?</u>

Yes. Within certain industry sectors, independent comparables are virtually non-existent or not meaningful. This is especially the case in industry sectors where vertical integration has taken place. Moreover, even when independent companies are found, many difficulties are encountered in practice in obtaining and validating the available data for comparability and to make the necessary adjustments in this respect. When the 5 comparability criteria of the Guidelines are strictly applied, one frequent outcome is that no independent comparables should be retained. This is often due to the size-difference of the independent comparables vis-à-vis the tested party. And even if the size is comparable, a subsidiary of a multinational taxpayer is often not precisely comparable to an independent company of the same size due to their different functional and risk profiles. The subsidiary will be a part of a multinational operation often having limited functions and relying on headquarter support, whilst an independent enterprise undertakes all relevant functions related to its operations.

Considering the difficulties that transfer pricing practice experiences in retrieving comparable independent transfer pricing data (or even the complete lack thereof), information on third-party enterprises that are part of another MNE group may often be regarded as a valuable source of information. However, it should be emphasised that the issue of dependent comparables (i.e. the degree of evidence for transfer pricing) is put in its proper perspective by the Guidelines, the taxpayers and the tax authorities, and that these can never be sufficient in and on themselves to make a proper assessment of the (non-) arm's length nature of a pricing policy.

<u>2- Is it an important issue?</u>

Yes. Using dependent comparables is an easy solution for tax authorities, as they can leverage on information accumulated during tax audits. However, the taxpayer is at a significant disadvantage because such comparables are often kept secret. Experience teaches us that tax authorities sometimes make reference to dependent comparables for adjusting transfer prices, although it is in contradiction with the OECD principles and the definition of the arm's length standard to do so. In practice, there are some circumstances where these dependent comparables represent the only information available, and hence it is tempting to refer to such "industry norms", although these are not to be considered as comparables as defined under the Guidelines.

3- Experience with respect to this issue

In most countries, dependent comparables are often used to trigger in-depth transfer pricing audits. Where the margins of a taxpayer under scrutiny are not in line with the "standard" margins for that taxpayer's sector and its competitors, tax authorities feel an in-depth tax audit of the transfer pricing policy of that taxpayer is necessary. In most countries, secret dependent comparables are therefore treated as a red flag, although once the audit is opened, tax authorities mostly use third party data as a basis to assess (and possibly adjust) a company's transfer pricing. What makes the issue of dependent comparables difficult to monitor in such cases is that tax authorities are nevertheless often influenced by the results of dependent comparables.

Notwithstanding the above, other tax authorities go a step further and often refer to dependent comparables as a basis for establishing that transfer prices do not meet the arm's length standard and for quantifying the corresponding transfer pricing adjustment. They consider that such "dependent" comparables are meaningful comparables, since one should not consider that any controlled company does not comply with the arm's length principle by the mere fact that it is part of a multinational group. Therefore, dependent comparables are considered as providing a sound reference to "normality". However, they rarely provide sufficient information on such comparables (which remain secret), so that the taxpayer is in a difficult position to comment on whether the key comparability criteria are met, and whether the comparison (albeit with an intra-group situation) is meaningful. It should also be noted that this approach is definitely not shared by all revenue authorities and for example will unlikely stand up in disputes with US Competent Authority.

4- Suggestions for improving the existing guidance in the Guidelines with respect to this issue

Transfer pricing practitioners regard publicly available information on third-party enterprises that are part of another MNE group and have material transactions with other members of the group as providing useful information on industry practices, but this should as such not be used as a basis for adjusting transfer prices.

Indeed, a diligent manager may make a reasonable effort to assess the risk profile of a company's transfer pricing policy and the need for adequate accompanying documentation by comparing the profitability of the company with the results realized by its main competitors in its industry. It is nonetheless advisable for both taxpayers and tax authorities to treat such data with great caution. Neither party should rely on dependent comparables with a substantial number of intercompany dealings on an exclusive basis. Dependent comparables are in themselves not sufficiently robust to be used by the tax authorities to defend an adjustment. All, however, depends on the extent of related party dealings these dependent comparables are engaged in. Note that publicly available third-party data in the US is typically at the segment level that is arrived at by allocating headquarter costs to the contribution margin of the segment. Experience has shown that these allocation keys are not always consistent with the Guidelines and render the information suspect at the operating profit line .

Of course, relevant question in this debate is the definition of ‘dependent’.

Issue: COMP 3 – Need to obtain third party information relevant to the review of the five comparability factors

1- Is it a real issue?

Yes, the availability and quality of data for independent entities as comparables is extremely important for an analysis of the arm’s length character of related party transactions. However, in practice, it is observed that the availability of such adequate comparable data is often so restricted that reviewing it according to the 5 comparability factors has proven to be a very difficult task to perform.

2- Is it an important issue?

It is quite difficult to find information on unrelated entities that will satisfy the strict requirements of the five comparability factors (characteristics of property or services, functions, contractual terms, economic circumstances and business strategies) for the following reasons:

- Disclosure requirements vary substantially from country to country and also depending on whether or not a company is listed at a stock exchange. Even the strictest US SEC requirements will not meet all the standards of the five comparability factors. There are countries where local privately-owned companies are generally not legally required to provide any filings of their statutory accounts. All that is required by law in the hands of these companies is to produce financials certified by independent auditors.

- Very few countries have country-specific databases with information on local independent companies.

- Databases generally provide information that is even more limited than filings as the focus is more on the financial information of the companies included and less on functions, strategies and contractual terms. It is quite often the case that the business descriptions provided are incomplete or not accurate at all. Hence the database information must be supplemented by other sources including a review of actual filings, public websites and industry sources.

- Different accounting standards are quite often impossible to reconcile and this problem is not resolved completely even in European or global databases. This directly influences the application of certain transfer pricing methods. Upcoming harmonization of accounting standards, such as IAS, may narrow down these discrepancies for public companies, but is unlikely to remedy all.

- Where segmented information is available (such as in the US where publicly traded companies have to report on a segmented basis), its usefulness is limited in that one cannot be sure whether the allocation methodologies used to create the segmented financial data are consistent. This is particularly true for operating expenses. This situation also puts limitations on how far the comparability factors can be applied on a transactional level.

3 - Experience with respect to this issue

Based on the quality and details of the presently available information (filings, databases and other sources such as the Internet, company publications, etc.), despite reasonable efforts, it is difficult and time-consuming for taxpayers and their advisers to comply strictly with all five comparability factors. They may have no choice, but to compromise in arriving at the results of analyzing comparable data.

In practice, it is possible to obtain publicly available information on the first two comparability factors (characteristics of property and services and functions). However, even for these, the review will also be limited by other parameters and must be considered in light of the size and relative transfer pricing risk faced by the taxpayer. For comparability factors three to five (contractual terms, economic circumstances and business strategies) information is not readily available to meet the comparability standard. This difficulty is mainly triggered by the nature of the publicly available data, which is in most cases extracted from filings and existing commercial databases. Such commercial databases are initially constructed to serve purposes other than transfer pricing, and are therefore not in an ideal format for the transfer pricing profession. Nevertheless, it is in many cases the only recourse for transfer pricing practitioners.

4 - Suggestions for improving the existing guidance in the Guidelines with respect to this issue

The five comparability factors as set out in the Guidelines are a good summary of what taxpayers and tax authorities should consider when evaluating data. They should not be used as a prohibition to use such data available.

The standards of the five comparability factors should however be relaxed to a form of guidance with greater emphasis, practically speaking, to reflect the quality and details of the information that is actually available and publicly accessible to taxpayers, and with a focus on property and functions, since these are the two characteristics that can still best be identified from the available data.

Whilst profit-based methods and their wider application are in many instances more suitable because of the limitations inherent in the presently available data, the transaction-based methods should still be considered prior to utilising profit-based methods.

Further, the Guidelines should discuss the use of foreign publicly available information and commercial databases by the taxpayer / advisor when it is difficult to obtain local information. This discussion should be put in the context of the differences in economic circumstances, accounting standards and other factors that may throw up comparability issues between jurisdictions.

Issue: COMP 4 – Need to ensure objectivity of the list of external comparables

1- Is it a real issue?

Knowing for certain whether the set of comparables selected is complete and adequate is surely a real issue.

This issue stems from two main factors:

1) Sources of available information;
2) Selection criteria.

Dealing with the first factor, it is important to note that the use of commercial databases normally results a relatively high number of potential comparables with (more) limited efforts in terms of time spent and resources engaged for the selection process. This means that it is necessary to assume from the outset of the analysis that the commercial database selected fulfils adequate reliability criteria in terms of completeness and fairness of the data it includes.

Another source of information are proprietary databases which are mostly used to benchmark transactions. With proprietary databases, reference is made to compilations of publicly available information organized in a manner that is most efficient for transfer pricing purposes. Because information in proprietary databases is usually not collected in a systematic fashion but rather gathered through prior searches, they may contain certain weaknesses in terms of the completeness of the data, but may nevertheless bridge the gaps left by commercial databases.

From a practical point of view, both commercial and proprietary databases may contain certain weaknesses in functional description. This is unavoidable.

Another possible approach could be to select comparables based on the knowledge of the selected sector of activity. In any case, this alternative type of research could ensure that the selected comparables are better and more reliable. Often, this type of analysis is not completely sufficient, however.

After having determined the source of the information to be used for the research, the selection of comparables is to be carried out in compliance with criteria that are based on "principles" rather than on case-specific rules. This can lead to the application of variable comparability criteria, which could result in the exclusion of some comparables that would not have been excluded, had different selection standards been used.

This problem could be solved by means of a detailed and timely audit trail explaining the search process, what standards of comparability have been used, and what exclusion criteria have been adopted. Even if this is not actually sufficient to ensure the complete objectivity of the selected set of comparables, it can be helpful to limit the risks of discretion in the selection of comparables. A taxpayer that has considered the data available and taken reasonable steps to interpret it to derive a result should be entitled to rely on that result.

Such issues can be even more eminent if comparables are selected without using commercial databases.

2 – Is it an important issue?

The absence of objectivity in selecting comparables could result in remarkable distortions of the results.

Practice shows that, taking into account the actual behaviour of tax authorities in terms of in-depth scrutiny, the sole way to limit this risk is to describe, document and carefully substantiate a comprehensive selection process. However, this course of action only provides the taxpayer with a defense-tool of the position taken rather than reasonable certainty that the parties involved will consider the selection process carried out to be correct and adequate.

The absence of a single agreed methodology adopted by both taxpayers and tax authorities in terms of (i) selection of the information sources and (ii) selection/exclusion criteria means that there is little prospect of ensuring the objectivity of the set of comparables and implies a certain degree of discretionary power in the selection process.

The more the selection of comparables is affected by arbitrary criteria, the more the selection can be challenged by the tax authorities, leaving the taxpayer with limited ammunition to defend its position or arguments in the case of an assessment.

3 – Experience with respect to this issue

This issue ends up being fundamental with regard to the different approaches that the tax authorities can adopt in the case of an assessment.

In the case of an assessment, it can happen that the tax authorities proceed with additional selections that, depending on the absence of generally accepted standards, could differ from those previously performed by the taxpayer, leading to different results.

From the taxpayer's perspective, the issue comes down to the degree to which the position taken in performing the selection process can be defended compared to that adopted by the tax authorities. This leads to additional costs being incurred by the taxpayer and can lead to penalties even before a final ruling is issued by a court.

<u>4 – Suggestions for improving the existing guidance in the Guidelines with respect to this issue</u>

A possible solution to this issue could be for the Guidelines to clearly emphasize the need for documentation and an explanation of the search process. These guidelines should take into account some of the inherent difficulties in obtaining publicly available information faced in various jurisdictions/ regions throughout the world.

These guidelines, applicable to both taxpayers and tax authorities, would contribute to reducing the arbitrary nature inherent in the selection and challenge process and decrease the risk of tax litigation. Consequently, the taxpayer would no longer be in a situation in which he is obliged to prove and justify the position taken, but would only have to prove that generally accepted guidelines have been met in the selection process carried out.

These guidelines should not be too rigorous given the differences in availability of information and its quality, from country to country, and from industry to industry, varies so greatly that to attempt to set standard principles and guidelines will run the risk of reducing the flexibility necessary to find an answer. However, the basic principles should be made clear. These are:

1. The process adopted by the taxpayer and the tax authority in undertaking the search process and assessing the quality of data should be clearly documented.

2. The standards adopted in the search process and in the assessment of the quality of comparables should be relative to the materiality of the transactions so as not to place an inequitable burden on taxpayers.

Issue: COMP 5 – Determination of the years to be covered and use of multiple-year data

<u>1- Is it a real issue?</u>

It is often the case in practice that taxpayers rely on previous-year data to determine future transfer pricing, because third-party information is only published after the year end.

Three issues result from determining transfer prices based on data from previous years.

First, the results from the previous years may have been influenced by special circumstances only applying for those years. It will therefore not be appropriate to aim to reach the same results in subsequent years. The issue has to do with how independent parties determine prices. The price-setting must be done so that a certain profit from the transactions can be anticipated. Naturally, independent parties must also to a certain extent rely on historical data when determining the prospects for future years, but this can only be a proxy. If the economic outlook is different from the actual results for previous years, it should be expected that the anticipated profits will be different from the profits actually made in previous years.

Second, if the results at the year-end are adjusted in line with the benchmark study used to set the prices, the price adjustment will have the effect of disregarding the economic circumstances of the year in question, which by nature also had an effect on the results of independent parties, be it that this information will only be available in subsequent years. Therefore, whether an adjustment should be made depends on how the risks are divided between the parties and how the unexpected circumstances or developments during the year might have affected the pricing between independent parties. Especially an adjustment at the year-end may be warranted where the parties have not revised the price setting during the year in line with the changing economic circumstances. In this case it should be considered whether parties to an uncontrolled transactions would have made price revisions during the year.

Third, it is relevant to consider whether the prices should be adjusted once third party information is available for the year in question, which will often take between 6 months and one year after the year-end. In Europe, the updating of the financial information may even take longer than one year. Theoretically, it could be argued that an adjustment should be made retroactively once this information is available, as this information is the evidence of how independent parties traded in the relevant period. However, given the inexact nature of database searches and the need to lessen the administrative burden on the taxpayer, adjustments should generally not be made retroactively, unless it can be shown that the budgets were based on materially flawed circumstances. This also has the consequence that the tax authorities should not make an adjustment based on database searches for the year in question unless they can prove that the original price setting was based on materially flawed circumstances.

2- Is it an important issue?

The issue is important as companies using a profit-based methodology such as TNMM or CPM are often faced with the problem of not having current-year comparable data in a timely basis to allow end-of-year adjustments to target income levels.

3 - Experience with respect to this issue

Several approaches to this problem are possible and often observed in practice.

It has become commonplace in APAs and other dispute resolution settings (at least in the United States) to establish a single range of acceptable results applicable to a forward-looking multi-year period. Hence, the target range of operating profit applicable to years 2003 through 2006 might be established at one stage based on the results of comparable companies for the three-year period from 2000 through 2002. The taxpayer is then free to adjust transfer pricing as each year unfolds to meet that target range. When the APA is renewed for the 2007-2010 period, say, the target range would be recalibrated based on comparable company results for 2004 through 2006.

Such an approach provides a high degree of both certainty and flexibility. In broad areas of potential transfer pricing dispute, including distribution companies, contract manufacturing and contract research, it appears that comparable company results are sufficiently stable over time that such an approach is fair both to taxpayers and the government. This is particularly true where the sample of potential comparable companies is sufficiently large to produce statistically meaningful, robust results. It would be salutary if the Guidelines were modified to include examples that affirmatively approve this type of approach, even in cases that do not involve APAs.

In situations that do not involve a prospective establishment of target ranges in an alternative dispute resolution setting, like an APA, the problem can be difficult. It is reasonably typical for companies to establish target ranges of acceptable results based on comparable company data that lags behind actual operations by one year. Hence, taxpayers may test their 2003 results under a TNMM or CPM methodology based on comparable company results for 2002. Even this one-year lag does not provide a company with the ability to fully apprehend the required target margin at the beginning of the year, since comparable data does not become publicly available until several months after the end of the year to which it relates in most countries. Tax auditors appear to approve this approach.

Other companies have tried to establish more stability in their planning process by establishing target ranges based on multiple year data. Hence, the target range of operating margin for a distributor in 2003 could be established on the basis of three years of comparable company data for the period from 2000 to 2002. Even though 2002 comparable data will not be available until well into 2003, the use of multiple years of comparable company data will generally cause the 2002 results to have a diminished impact on the target range. Generally the mismatch of years does not present any problems provided that the number of years' data used reflects a full economic cycle and appropriate consideration is given to fundamental shifts in the market. This allows for greater certainty for companies without any real loss of government comfort with the approach. Again affirmative approval of these sorts of approaches, which are not often thought to be controversial, would be a very helpful development.

Tax authorities in practice tend to select companies for further scrutiny on the basis of past year data. In the context of transfer pricing audits however, as a general principle, the tested party's results are benchmarked against the comparables' results over the same time period. If comparable companies' multi year data is used, the adjustment should be determined by reference to the average results of the tested party over the same time period. In situations where arguments are raised by tax authorities, it is generally a response to a different issue, such as a highly results oriented comparable selection process, the choice of a group of comparables that is too narrow to be statistically significant, or the complete absence of credible comparable data from functionally similar companies. While tax rules should require use of current year comparable data, these other issues are legitimate and should be addressed on their own terms.

4 - Suggestions for improving the existing guidance in the Guidelines with respect to this issue

Even in situations where the approach to comparable data is sufficiently flexible in temporal terms to allow some predictability in target margins, it is not always possible for a company to bring its financial results within the arm's length range without year-end or post year-end adjustments to income. Unexpected year-end expenses, inter-company expense allocations, revenue shortfalls, and similar issues can cause even the best intentioned taxpayer to generate results outside an arm's length range.

In these situations, applicable local country tax rules and the Guidelines should permit year-end and post-year end adjustments to operating results in order to accommodate the reporting of arm's length results on tax returns. Unfortunately, many countries are quite resistant to such adjustments, particularly where they have the effect of reducing local country operating income for the taxable year. Technical and procedural hurdles are often imposed that make these types of adjustments difficult. Often, countries refuse to permit such adjustments unless an intercompany agreement clearly provides for the adjustment, and even then the adjustment may be challenged.

Consideration should also be given to the flow on effects, for example, transaction taxes such as VAT and customs. In many countries, it are these issues that render post-balance date adjustments unworkable. This should also be considered when amending the Guidelines.

Such antipathy to year-end adjustments to income is antithetical to smooth voluntary compliance with global transfer pricing policies. It reflects a belief that business results are more predictable and easily manipulated than is actually the case. We are mindful of the concern of some tax authorities that companies will tend to minimize income within an arm's length range of results if too much flexibility is provided. However, a more flexible approach, permitting the use of target ranges built on multiple prior-year comparable data and periodic adjustment of results to fit within those target ranges, including year-end or post year-end adjustments, will ultimately reduce the amount of transfer pricing controversy without compromising government interests.

Another alternative closely linked to the use of multi-year data would be to assess taxpayers on their financial results on a multi-year basis. In this situation, tax authorities would consider the financial results of companies over an appropriate time frame rather than year on year.

The use of multi year data is particularly useful in developing countries that have greater market volatility. In those cases, the use of multi year data reduces the effect of short-term variations that may be unrelated to transfer pricing. Moreover, in cases where foreign comparables are used due to the lack of local data, the use of multi year data reduces the differences resulting from business or economic cycles improving the reliability of results.

This approach would also eliminate one-sided adjustments by revenue authorities, who in practice adjust a taxpayers results only where the results fall below the arm's length range in a particular year (not where the result achieved is above the arm's length range). In reality this approach is what would occur in an independent situation as the entity achieving a low result in year one would attempt to negotiate a better price in year 2 rather than requesting a refund in relation to year 1.

The key question however always remains whether actual dealings during the year produce arm's length results, making adjustments necessary to accord with arm's length dealings. The answer to this question would inter alia depend on the circumstances of each case, including the reasons why a taxpayer's results have fallen outside the range, as well as the practical hurdles to be overcome. As in a great number of OECD Member States, the fiscal result of a company is tantamount to the result for accounting purposes, it should still be possible – from an accounting point of view - to proceed with year-end adjustments, i.e. before the accounts have been audited or approved. In that respect, the question boils down to a mere time constraint.

Issue: COMP 6 – Choice of relevant sources of information, including but not limited to commercial database

<u>1- Is it a real issue?</u>

Can commercial databases fulfil the arm's length principle?

From a practical perspective, commercial databases are the best starting point for fulfilling the arm's length principle, in the absence of any reliable internal comparables. Regardless of whether comparability studies derived from commercial databases can theoretically be considered sufficient to support strict compliance with the arm's length principle as currently articulated in the Guidelines, the fact is that these databases are relied on by both taxpayers and tax authorities to set and review transfer pricing policies between international related parties.

The extent to which commercial databases are sufficient to fulfil the arm's length principle is indeed a real issue for taxpayers and tax authorities alike. Doubts are often cast upon the outcome of benchmarking studies derived from commercial databases. Such concerns are raised by both taxpayers and tax authorities, and often boil down to the question of whether it is the comparability study undertaken by the taxpayer or the study undertaken by the tax authority that is the more correct study.

2- Is it an important issue?

In one sense, the ability for commercial databases to fulfil the arm's length principle is a very important issue, in that it is a matter that often gives rise to a dispute between a taxpayer and a tax authority.

However, an alternative view is that it is not really that important, as commercial databases represent the best alternative for both taxpayers and tax authorities for setting and reviewing transfer pricing policies between international related parties. This is because the commercial databases are considered to provide the most effective and the best value for money mechanism of producing benchmarking data. The benchmark data can be used by the taxpayer as a framework for setting transfer pricing policies, or by the tax authority to assess the risk that a particular taxpayer's transfer pricing policy may be giving rise to an outcome that is not in accordance with the arm's length principle. So while the use of commercial databases to produce benchmarking data may have its weaknesses, it is realistically the most effective for both taxpayers and tax authorities to address transfer pricing issues. It should however be noted that one only reverts to commercial databases after the prospect of quality internal comparables has been eliminated.

3 - Experience with respect to this issue

Pros and Cons experienced with Commercial Databases

Among the pros of using commercial databases to form a view on the application of the arm's length principle are:

- that they are likely to be the most effective means of producing a comparability study by a taxpayer for a tested party;
- generally include extensive search capabilities to interrogate the database for the specific requirements of a particular taxpayer;
- databases can contain financial data on more than one territory or region;
- financial data is generally provided in a manner that facilitates financial analysis of the operating performance of comparable companies identified;
- the databases generally facilitate "what if?" analysis;
- from a tax authority perspective, it can provide broad estimates of operating performance useful in risk assessment;
- it is possible to develop economies of scale with repeated use of the database.

Some of the cons experienced include:

- a significant up-front cost to obtain a licence to use the commercial databases, likely to be prohibitive for taxpayers seeking to access the data on a once-off basis;
- databases can contain errors, both quantitative in terms of the financial data reported and qualitative in respect of the information provided on the companies included in the databases;
- availability of databases can make a commodity out of an important step in determining whether an arm's length outcome has been achieved;
- industry and functional categorisations of companies can be misleading or arbitrary, leading to incomplete samples.

Alternative Sources of Information

The general alternative to using the commercial databases for company financial data is to directly access publicly available financial data by contacting the regulatory body charged with administering company law in the relevant territory.

While it may be expected that all publicly available data has been included in the commercial databases, some markets are too small for the compilation of a database of publicly available financial information to be commercially viable. Also some publicly available data may be excluded from commercial databases by virtue of size, industry classification or some other criterion.

Practically, deciding not to use a commercial database results in a manual, two-stage process for undertaking a comparability study. The first step involves identification of potentially comparable companies from sources such as business directories, industry associations, internet research, telephone directories, etc. This also includes searching for information on the operating activities of the potential comparables identified and an initial screening to exclude companies undertaking activities that are not comparable with the tested party.

Secondly, for the potentially comparable companies remaining in the sample, a search is undertaken of the records held by the relevant regulatory body charged with administering company law matters in the relevant jurisdiction. Generally, this is now internet-based, but searches are performed on a company-by-company basis to determine the extent of publicly available financial data on the potential comparables. For a fee, copies of financial statements may be obtained, from which a final check on comparability can be undertaken and financial analysis performed.

The pro of this alternative method is that it generally results in a comparability study that is of a higher degree of integrity than using the commercial databases, for the reason that the financial analysis is directly derived from the financial statements obtained. However, the disadvantage with this alternative is that this procedure is time-consuming, expensive and difficult for tax authorities to repeat (i.e. loss of audit trail), and it is difficult to achieve economies of scale in the same manner as repeatedly interrogating the commercial databases. It is therefore clear that putting this approach forward as being "the" method would go beyond what one would expect from a diligent manager.

Another alternative source of information are proprietary databases that have been internally developed. These proprietary databases are compilations of third party agreements collected from the public domain (mostly in the United States). Searching for comparables transactions in public sources of information is a time-consuming process. The first step involves identification of classification codes or keywords that are likely to produce comparable transactions. The next step usually involves retrieving each potentially comparable transaction and reviewing its contractual terms.

The pros of using proprietary databases is that it allows for more efficient use of time, and creates economies of scale since prior searches can be leveraged from. The disadvantage is that searches conducted in proprietary databases cannot be replicated by tax authorities.

Methods by which taxpayers deal with countries with only limited public financial information

Generally, tax authorities in jurisdictions where there is little publicly available financial information are all too aware of this situation and make allowances for it in their appraisal of the transfer pricing policies of taxpayers in that jurisdiction. This might include using foreign data. However, tax authorities generally like to see an attempt being made by the taxpayer to initially obtain benchmark data particular to that jurisdiction. Once this step is undertaken, it may be reasonable to conclude that it is necessary to obtain benchmark data from another jurisdiction either to support a benchmark study based on limited local data, or to approximate expected returns in that jurisdiction in the absence of any local country benchmark data.

From the taxpayer's perspective, a number of different approaches are taken, generally depending upon the extent of the international rate of related-party dealings engaged in by the taxpayer in that jurisdiction and the taxpayer's assessment of the attitude of the local tax authorities to non-local source data.

The taxpayer may:

- Rely on a financial analysis from a small number of comparable companies identified, which, although insufficient for a proper statistical analysis, at least provides a range of outcomes based on local country data;
- Support a benchmark study based purely on local data with a secondary analysis from another market deemed to be comparable to that in which the tested party is located;
- Undertake a regional study drawing data from a number of jurisdictions within a particular geographical region ;
- Use the tested party's multi-year data so as to smooth the effect of market volatility;
- Attempt to derive geographic adjustment factors based on an economic analysis of the jurisdiction in which the tested party is located and one or more broadly comparable jurisdictions in which publicly available financial data is more widespread. Once the economic effects stemming from differences in geographic markets are calculated, the taxpayer may adjust the range of outcomes derived from the financial data from the latter jurisdictions to approximate expected returns in the jurisdiction of the tested party.

<u>4 - Suggestions for improving the existing guidance in the Guidelines with respect to this issue</u>

Commercial databases generally provide a cost-effective solution both to taxpayers setting their transfer pricing policies and to tax authorities charged with a review of the implementation of these policies in their jurisdictions. Using the commercial databases is not without its inaccuracies on the part of both the taxpayer and the tax authority, but it at least fulfils the need to have some benchmark data to hand in order to evaluate whether the arm's length principle is being adhered to by a tested party. The use of commercial databases for benchmarking studies is in a sense the best effort a taxpayer can make. One should always bear in mind however that the raison d'être of a commercial databases is not just for transfer pricing purposes, but to serve as management and financial tool.

Issue: COMP 7 – Definition of comparability adjustments where they are appropriate

1- Is it a real issue?

Yes, adjustments are inevitable in order to account for material differences between related transactions and the comparable uncontrolled situations that significantly affect the prices charged or returns required by independent enterprises in order to achieve arm's length pricing.

There are a number of factors that determine the level of comparability between one company and another and these need to be considered at the various stages during the comparables analysis process. However, transfer pricing practitioners find little analytical and practical guidance to account for pricing adjustments in the Guidelines. The Guidelines for instance acknowledge that, for achieving comparability, appropriate adjustments should be made for material differences arising as a result of:

- *Product - service – intangible property characteristics* (including, amongst others, the physical features of the property, its quality and reliability, and the availability and volume of supply; in the case of intangible property the form of the transaction as licensing or sale, the duration and degree of protection)

- *Differences in functions performed, risks assumed and assets deployed* by any independent enterprises with the tested party (including frequency, nature and value of functions, type of management, differences in market risks, credit risks, and so forth)

- *Contractual terms* (including delivery, credit terms, guarantees, etc.)

- *Relevant specific economic circumstances* (include the geographical location; the size of the markets; the extent of competition in the markets and the relative competitive positions of the buyers and sellers; the availability (risk thereof) of substitute goods and services; the levels of supply and demand in the market; costs of production, including the costs of land, labour, and capital; transport costs; the level of the market (e.g. retail or wholesale); the date and time of transactions; and so forth)

- *Business strategies* (such as those involving market penetration or expansion of market share).

2- Is it an important issue?

Yes, since the Guidelines are vague with respect to how the adjustments should in practice be valued. This does not prima facie constrain transfer pricing practice, as the feeling is that transfer pricing analysts must have sufficient room for manoeuvre to assess the appropriate arm's length adjustments on a case-by-case basis. It must be acknowledged that no "one-size-fits-all" approach can be included in the Guidelines for each category of adjustments. There are however adjustments which are more common, whilst others are more difficult to make. This view is in line with the Guidelines, as these also recognize that for some differences (e.g. product quality, geographical markets, intangible involvement, etc.), adjustments are difficult if not impossible to make.

3 - Experience with respect to this issue

It is recognized that, whilst the impact of some transactional differentials can be neutralized through adjustments in a comparability analysis (e.g. volume effects, working capital differences), determining other adjustments might prove to be far more difficult. Adjustments for differences in product quality, economic circumstances, geographical market conditions, business specifics, market level and brand premium rarely ever provide definitive proof that pricing is adjusted in accordance with the comparability requirement of the arm's length principle. The latter is the crux of the matter, as these adjustments (if at all possible) would require the application of fact-specific and complex adjustments for which it would be difficult to envisage the Guidelines being modified.

Importantly, it needs to be recognised that differences in profitability may reflect inefficiencies in one business relative to another. In such cases, adjustments would serve to reduce comparability rather than increase it.

Moreover, experience with the tax authorities has indicated that they approach such sophisticated adjustments with much caution.

4 - Suggestions for improving the existing guidance in the Guidelines with respect to this issue

Supplementing the current Guidelines with guidance on at least the feasible adjustments can only be welcomed by the business and tax community. The Guidelines should ideally provide a common platform of principles and concepts that ought to be adopted in performing these adjustments, including the circumstances under which they would typically be undertaken and guidance as to the process by which the specific formula to be applied. By way of example, one can refer to adjustments for e.g.

- volume effects of transactions
- working capital differences (inventory, levels of accounts payable/accounts receivable): it is generally accepted amongst transfer pricing specialists that such differences in specific contractual terms constitute a prefinancing difference and can be addressed by making adjustments for the time value of money at an appropriate interest rate or the weighted cost of capital.

However, it is recognized that, whilst the impact of some transactional differentials can be neutralized through adjustments in a comparability analysis, determining other adjustments might prove to be far more difficult. Experience with the tax authorities has indicated that they approach such sophisticated adjustments with a great deal of caution. It is therefore felt that the Guidelines in such case should stress that the arm's length principle is indeed the starting point. The Guidelines may in this respect stipulate that, although the feasibility of adjustments should be assessed on a case-by-case basis, if numerous or sophisticated adjustments must be made, the option of revisiting the search strategy to obtain a stronger comparables set must not be ignored by the taxpayer and tax authorities (e.g. by extending the time-frame, by opening up the search to more product categories, business cycles, by searching for data in other countries etc.).

The continuously changing business environment and the current slowdown of the economy have put a particular strain on transfer pricing in general and comparability/adjustments in particular. The timing difference, which is inherently linked to the analysis of publicly available data, means that selecting comparable financial data on a real-time basis will often be difficult (see COMP 5). It is felt that although the Guidelines cannot be made sufficiently detailed to cover all these business constraints, they should be sufficiently flexible to allow for innovation in approaches to improving comparability. Further, guidance should nevertheless be given on issues such as the appropriateness of adopting a loss split or an industry-wide analysis as alternatives for making highly sophisticated adjustments.

Issue: COMP 8 – Interpretation and use of data collected

1- Is it a real issue?

Cf. below under 4.

2- Is it an important issue?

Cf. below under 4.

3 - Experience with respect to this issue

Cf. below under 4.

4 - Suggestions for improving the existing guidance in the 1995 TP Guidelines with respect to this issue

How should loss-making comparables be dealt with?

It is generally acknowledged that independent companies have no guarantee that losses will not occur. Taking cyclical businesses such as the semiconductor industry as an example, one finds that - depending on the economic cycle - years of extreme profits are followed by years of extreme losses. If loss-making comparables are therefore excluded, comparables with unusually high profits also have to be excluded.

In certain circumstances, e.g. if the tested party is an entity that bears only very low risks, a loss-making comparable may indicate that it is not truly comparable with the tested party and therefore has to be excluded. However, in this case also comparables showing high profits may not be truly comparable to a low risk/small function entity and may have to be excluded as well.

A general rule that loss-making comparables should be excluded would distort the economic picture and would neglect the rationale of independent transactions. It should be left to the decision of the transfer pricing practitioner whether - after due consideration of the relevant facts – loss-making comparables should or should not be excluded.

Do you consider the range should include all the data obtained or should the extreme results be excluded?

The purpose of defining ranges is:

- to establish a data set that reflects the underlying distribution of the comparable data; and
- to determine whether the taxpayer’s data has been generated by the same underlying distribution of the comparables data.

To achieve the above objectives, it is necessary to identify and exclude outliers which are not generated by the underlying distribution. While an outlier is an “extreme result”, not all extreme results are necessarily outliers. Where an extreme observation is merely a manifestation of the natural variability inherent in the data (for example where it reflects a skewed underlying distribution), the result should be retained and considered in the same manner as the other observations in the sample.

The answer to this question also depends to some extent on the size and reliability of the obtained sample. A general rule to exclude extreme results may be arbitrary and may not fit the individual case. Statistical techniques for detecting outliers should be used to decide whether results are so extreme that they should be excluded as unrepresentative outliers. These techniques typically involve the calculation of a test statistic which is then compared with a “critical value” based on the theory of random sampling to determine whether the extreme results are in probabilistic terms ‘too extreme’ to have arisen from the underlying distribution and therefore whether they should be retained or excluded.

Where the extreme results are not influential such that the results of the analysis are essentially unchanged when they are removed, then the issue is less important.

Another related issue concerns the averaging versus the pooling of comparable data in the context of samples that contain a mix of time-series and cross-sectional data. The approach often used by practitioners and revenue authorities is to average the time-series data for the years available and calculate the range of the average data. An alternative approach is to pool all the individual data points and compute the range. Often, the results under the two approaches can be significantly different.

Averaging gives each comparable within the comparable set equal weight. Under pooling, however, a comparable with missing data over some years is given less weight, as fewer observations are included in the data set. Averaging generally creates a narrower range relative to pooling because it masks outliers in the time series observations. On the other hand, pooling generally creates a wider range.

Guidance is required as to when either each method is more appropriate in specific circumstances.

Should the top and bottom of the range be systematically removed (e.g. by using an inter-quartile or similar type of range)?

The transfer pricing practitioner should exercise judgement in processing the data and calculating an arm’s length range rather than following a rigid rule such as the use of the interquartile range.

Because the interquartile range ignores half the observations in a sample, using it to establish the range can potentially leave out relevant information from observations that are not outliers.

The reliability of the interquartile range is dependent on the nature of the underlying distribution of data. The interquartile range is designed for normal or bell-shaped distributions, and is not appropriate for non-normal (e.g. skewed or bi-modal) distributions. Therefore, if the interquartile range is to be applied, the first step would be to understand the shape of the underlying distribution of the sample data.

An interquartile range may be useful for tax authorities to define a safe haven range and thus to avoid lengthy controversies with the taxpayer on the exact appropriate profit. However, the comparability analysis itself should not systematically remove companies from the range, if they are truly comparable to the tested party. Where some doubts exist over strict comparability, as they often do, the degree of that doubt should influence the use of a specific range. The interquartile range may be appropriate. So may the interdecile range.

Should the answers to these questions be different depending on the "quality" of the comparables?

With reference to loss-making comparables: no, the answer given under for the first issue (loss-making comparables) should not differ. With reference to the second and third issues (extreme results and loss-making comparables respectively), the answer may vary with the size and quantity of the available sample. For example, where there is not enough comparable data so it is not practicable to ignore any of the data, then the entire set of imperfect comparable data that has been selected for application of a transfer pricing methodology should be considered.

Generally for larger samples, where all material differences between the comparable and tested party data have been eliminated, such that all data in the sample have a similar level of comparability and reliability, then the arm's length range should consist of the entire data set. Where all material differences between the comparable and tested party data have not been eliminated, then appropriate statistical techniques as described above should be employed for establishing an appropriate arm's length range.

Issue: COMP 9 – Specific comparability issues when applying transactional profit methods

1- Is it a real issue?

Yes. (see below under point 2)

2- Is it an important issue?

As stated in the Guidelines, the TNMM is less sensitive to some discrepancies that may exist between the controlled transaction and the third party transactions, for instance differences in accounting standards as also differences in products or functions. In practice this is an important reason why the TNMM is used instead of the traditional transactional methods (such as the resale price method), simply because the relevant (financial) information is not available. Quite often TNMM is used in combination with the resale price method, simply by adding back (budgeted) operating costs to the targeted operating margin. A complicating factor here is that the TNMM at a company level does not consider the level of third party operating costs.

3 - Experience with respect to this issue

Profit methods are usually not applied on a detailed transactional base, but on a product group, divisional or total company basis. This results from a lack of information at a detailed level. In some cases Revenue Authorities use the TNMM on a whole-of-entity basis despite transactional information, so as to adjust the results of taxpayers such that a taxable profit is achieved.

Transactional Net Margin Method

Practice shows that the TNMM is used quite often, especially where determining the remuneration for companies with straightforward functions, assets and risks such as low-risk distributor-type companies. In most cases the targeted operating margin is then applied at a total company level and not necessarily for each individual transaction or product category. In straightforward cases, this is perfectly reasonable and is often the most reliable approach. For complex tested parties, however, the TNMM often proves to be inappropriate, as it does not easily reflect aspects such as intellectual property rights, levels of markets, etc. Applying a TNMM in these cases may incorrectly assume that all variations in profit from the comparables are due to non arm's length pricing.

A potential weakness of TNMM is that the net (operating) margin can be influenced by various factors (e.g. inefficiencies at operating costs level) that do not have the same effect on gross margins. However, at the same time the TNMM may afford a practical solution to otherwise insoluble transfer pricing problems. Therefore, the TNMM should be used sensibly and with appropriate adjustments to account for differences. (Guidelines paragraph 3.34 – 3.39)

TNMM can be applied to the combined results of more than one transaction or even on a company-wide basis instead of per transaction. This would be the case for less complex functions (e.g. low-risk distribution), situations where the transactions are similarly characterized (i.e. same transaction type) or where transactions are so interrelated that they are more reliably evaluated on an aggregate basis. This would require further guidance as to what constitutes a transaction type (based on the intensity of assets employed, risks borne and functions performed).

Profit Split Method

The Profit Split Method (PSM) is in our experience less frequently used (subject to comments below on the Hybrid Profit Split Method), particularly on a transactional level, due to difficulty in obtaining external market data of profit splits achieved by independent third parties. Its use is therefore limited in practice to the most complex cases, say those where both parties to a transaction own valuable intellectual property, and it is not used where the position of one of the parties is more straightforward. In exceptional cases, then, a PSM is applied, often on the basis of a residual profit analysis, after determination of the remuneration for the routine functions and risks of the parties involved. The subsequent split of the residual profit requires a tailor-made approach in determining the allocation key(s) and could tend to have arbitrary elements.

The arbitrary, subjective elements referred to above could lead to lengthy discussions with tax authorities on the actual profit split ratios and the comparability factors to be applied. Therefore, this is an important issue and more practical guidance in this area could clarify the appropriate approach to be followed.

It is worth mentioning that some form of profit-split analysis, usually on an overall-company basis, is often made as a sort of sanity check on the outcome of a traditional transactional method, in terms of overall profit allocation between the parties involved.

Hybrid Profit Split Method

Consideration should be given to approaches such as the Hybrid Profit Split Method (HPSM). The HPSM is a combination of the TNMM and the Profit Split method, which is increasingly used by certain countries in joint APA processes. The HPSM provides a middle ground in satisfying the differing tax authorities' profit expectations, essentially allowing (cross-border) distributors to "share" in losses (to a point) over respective countries. Given the prevailing economic conditions in some countries, this method is increasingly appropriate. As such, the comparability issues raised in respect of the TNMM and the subjective elements in determining the actual profit split ratios of the tested party raised in respect of the profit split lines area are also relevant in applying the HPSM.

4 - Suggestions for improving the existing guidance in the Guidelines with respect to this issue

It would be helpful to obtain further practical guidance from a comparability perspective on the application of TNMM on an aggregate or company-wide basis rather than on a transactional basis, taking into account the fact that this method has some obvious advantages particularly in straightforward cases. Specific guidance should be provided as to the limited circumstances in which a TNMM on a company-wide basis should be applied. It would be expected that the factors considered would be the criteria of comparability, the availability of data and the reliability of the result in the context of the actual international related-party transactions being considered.

Further guidance would be welcomed in respect to the determination of profit-level indicators to be used and in what circumstances when utilising a profit method.