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**From:**  
Michelle Legault

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**Subject:**  
Working Party No. 6 (WP6) of the OECD Committee on Fiscal Affairs

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# Deloitte.

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November 30, 2006

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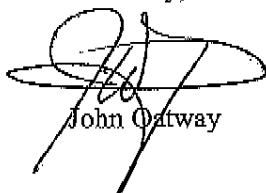
Dear Mr. Owens:

The member firms of Deloitte (hereinafter referred to as "Deloitte") are pleased to provide the following comments in response to Working Party No. 6 (WP6) of the OECD Committee on Fiscal Affairs' public invitation to comment on the series of Issue Notes regarding comparability, dated 10 May 2006.

Deloitte agrees that the issue of comparability is an important concern for the business and tax practitioner communities that has significant implications for the practical application of transfer pricing rules by taxpayers around the world. The comparability issue also has significant implications for the resolution of double taxation under the Mutual Agreement Process (MAP). Despite the increased attention that transfer pricing has received globally since the release of the 1995 *Transfer Pricing Guidelines for Multinational Enterprises*, we have not observed any convergence in the approaches adopted by local tax authorities regarding the identification, selection, or application of comparable data. If anything, the divergence of views has increased. In some ways this is not surprising, given that national governments proportionately have the greatest interest in the outcome of the analysis, assuming related taxpayers are taxable in the relevant jurisdictions at relatively the same rate. Furthermore, the growth in both the vertical integration and centralization of global operations has made it increasingly more difficult to find good quality comparable data.

Deloitte applauds the Working Party's efforts to provide practical guidance and clarification on the issue of comparability, and looks forward to the results of this work. Please find our detailed comments on the Issues Notes attached as an appendix to this letter.

Sincerely,



John Oatway

cc: Ms. Caroline Silberztein

## **Appendix: Deloitte's Comments on a series of WP6 Issue Notes on Comparability**

### **Issue Note: Putting a Comparability Analysis and Search for Comparables In Perspective**

Deloitte agrees that it is important to consider the "conditions" that would have been imposed between independent parties. However, practical experience suggests that as a result of both vertical integration and the centralization of certain activities, it is common for MNEs to have commercial arrangements and "conditions" that differ significantly from those found between independent parties. These differences usually result from differences in fundamental business operations, and not from any plan to redirect functions or risk to a specific locale. In addition, independent parties often enter into a wide range of business arrangements, which are supported by agreements with an equally wide range of terms and conditions (e.g., short- and long-term contracts).

We agree that a review of the "conditions" of both the controlled and uncontrolled transactions must be considered as part of a transfer pricing review. However, we would strongly suggest that the revised guidance specify those instances in which deviations from the "conditions" found in independent transactions should be respected, and how those deviations should be factored into the pricing model.

Relating the functional analysis to both the tested party and potential comparables is the key issue. In a practical sense, determining what constitutes a reasonable "standard of comparability" remains a difficult concept. The functional details available regarding comparables may not always be as comprehensive as the functional detail of the taxpayer. Comparability is an even greater problem in those countries that lack publicly available financial information on local companies (that is, when there is a need for additional adjustments, including accounting and geographic market adjustments).

We agree that further clarification of the "prudent business management" principle would be helpful. A cost/benefit analysis should certainly be a consideration in this discussion. We also agree that transfer pricing rules have become quite cumbersome and that pragmatic solutions would be helpful, not only for the small and medium-sized business community, but also for large MNEs.

Although it may become increasingly more difficult to apply the arm's length principle because of the lack of good comparable information, and although we agree that some pragmatic solutions would be desirable, it is not clear to us how creating a "theoretical arm's length environment" as suggested in paragraph 20 of the Issue Note would increase the objectivity or the certainty surrounding the process. This suggestion seems to promote the concept of recharacterizing the structure of actual transactions. Assuming that tax savings are not the motivation for the conditions of a controlled transaction, we believe that to recharacterize the transaction solely for the purpose of facilitating valuation may increase the likelihood of double taxation, and seems to ignore the reality of the MNE's environment. In our view, this suggestion is also contrary to the existing guidance in the 1995 OECD Transfer Pricing Guidelines.

### **Issue Note: Timing Issues in Comparability**

In general, Deloitte considers it unfair and unreasonable to expect taxpayers to be able to set transfer prices contemporaneously using data not available at the time those transfer prices are set.

The discussion in this section of the Issue Note seems to focus on the timing issue irrespective of the terms and conditions of the particular transaction or the transfer pricing method applied. Obviously, arm's length parties do set pricing prospectively, and do enter into contracts that specify the pricing for

extended periods of time - certainly beyond the fiscal period in which they are signed. For example, a long-term off-take agreement may be required to obtain the appropriate local financing and project approvals. In those situations, arm's length parties would be restricted to the data available at the time the deal was negotiated. In this arm's length setting, discussion of the pricing terms would not be reopened except in extenuating circumstances. This is similar to APA negotiations between tax authorities, whereby the agreement would be revisited only if a critical assumption is violated. For revenue administrations, comparability analyses are typically used to check transfer prices *ex post facto*. Taxpayers, conversely, face issues associated with the differences between setting prices *ex ante* and verification of those prices *ex post*. Deloitte suggests that the revised guidance discuss situations whereby arm's length transactions would have longer terms for legitimate business reasons, and we support the Working Party's efforts to clarify what information arm's length parties would consider in their dealing.

In our view, the Issue Note does not attempt to address the relative impact timing issues may have, depending on the methodology chosen. We would expect that the timing of the relevant data would have a more significant impact on the measurement under the CUP method than under the TNMM. Arguably, when profit-based methods are used, the relevant data cannot ever be contemporaneous. In addition, we believe it is important to consider the impact business cycles may have on otherwise comparable transactions or outcomes from a different time period. We suggest that clarification of these timing aspects by the Working Party would be a useful addition to the guidance.

#### **Issue Note: Internal Comparables**

Deloitte agrees that internal comparables (involving the tested party and unrelated parties) should be considered. However, it is our experience that internal transactions with third parties are often carried out on different terms or under very different circumstances than related-party transactions involving the same good or service. We frequently encounter situations in which tax authorities argue that a product transferred to a related-party distributor that sells to third-party end users should be priced the same as the "same product" sold to end customers in the local market, even though the local sales functions are performed by the related-party distributor. In such a case, the similarity of the products is only one of the characteristics to be considered.

The Issue Note takes a strong position that internal comparables are preferable to external comparables. In our view, it should be very clear in any guidance that internal comparables are not by default more reliable than external comparables. Further, we recommend that an internal comparable should not automatically be escalated to the level of exact comparable simply because the products are the same. Internal comparables should be subject to the same comparability analysis (functional differences, volume, level of the market, etc.) as external comparables to demonstrate whether they are in fact more reliable. We suggest that any guidance should make clear that the standard should be centered on the comparability of the transaction, not on whether the transaction is internally or externally derived.

In paragraphs 7 and 8, the Issue Note questions the use and motivations for the use of external comparables. In our experience, the increased use of external information is a reflection of the lack of internal information, and not a lack of diligence on the part of taxpayers in trying to identify internal comparables. We suggest that the Working Party not make general assertions on taxpayers' motivation for using external comparables.

**Issue Note: Determination of Available Sources of Information and Their Reliability**

While Deloitte understands the concerns regarding taxpayers' use of confidential information, we note that similar concerns also may arise between treaty partners when one jurisdiction makes use of secret comparables.

Deloitte concurs with other commentators that the use by tax administrations of confidential information that cannot be verified -- secret comparables -- is highly problematic, for reasons of fairness and transparency. Given the lack of transparency, we also question secret comparables' ultimate reliability in an audit, competent authority negotiations, or court process. With respect to MAP cases, we suggest that taxpayers should not be exposed to double taxation simply because tax authorities in one jurisdiction are unable to discuss or investigate information the other jurisdiction obtained in confidence.

As discussed earlier, finding reliable information regarding benchmark controlled transactions is becoming increasingly more difficult, at any cost. In our experience, detailed comparable information at the transactional level exists only in a small minority of cases. We anticipate that locating reliable comparable information will continue to be a challenge for taxpayers and tax authorities alike. While we agree that publicly available databases may have shortcomings, we also believe that in the vast majority of cases those databases offer the only cost effective means of verifying compliance with the arm's length principle. We recommend that the Working Party provide more specific guidance regarding the selection of comparables in publicly available databases.

There may be sources of information, such as customs data, that when available would provide evidence of trends within an industry that could be used to validate the results of more traditional approaches. This is a potential source of third-party pricing data that can add to the existing sources of information. We suggest the Working Party provide further guidance on the use of customs and other sources of comparable information not found in public databases.

**Issue Note: Uncontrolled Transactions**

Deloitte believes that the selection of comparables involves a series of relative judgments, including judgments about the reliability of methods given the availability of information. In many situations in which detailed comparable data are not available, judgments are required to decide between, for example, comparables in the same industry but different geographic market, or those in the same geographic market but different industry. When these judgments are made, it is important that they be explicit and explanations should be provided. We welcome any guidance regarding when and how comparable searches should be expanded.

We agree that transactions between associated parties should not be considered evidence of an arm's length transaction. We would expect that an explanation of the underlying logic and support for this principle may provide some insight for taxpayers and practitioners. We suggest that the Working Party consider including discussion on this point within the guidance.

**Issue Note: Examining the Five Comparability Factors**

Deloitte agrees with the comment that in practice the level of information available regarding external comparables is often insufficient to reliably assess differences in the five comparability factors.

What constitutes an appropriate 'standard of comparability' remains an elusive concept. We agree that the five comparability factors represent a good checklist of issues that must be considered in a comparability analysis, although practically it may be unfeasible to apply all five factors in a TNMM analysis. Focusing on these factors will improve the quality of comparability analysis. Their relative significance will vary, but functional analysis of both the tested party and comparables is a key element. However, a detailed comparability analysis using the five comparability factors may not be possible due to the paucity of available information on third-party comparables. Nonetheless, a comparability analysis should focus on identifying the differences between the tested party and the comparables along the five comparability factors, determining the effect of such differences in the analysis to be undertaken, and making adjustments to the differences, if possible. It must be recognized, however, that even if adjustments cannot be made, the external information may remain the most objective measure or test of an arm's length result. We acknowledge that the reliability of the analysis may be reduced in such cases. We recommend that the Working Party recognize the relative value of external comparables, even if one or more of the five comparability factors cannot be analyzed.

We recommend that the guidance clearly recognize the practical constraints regarding the comparable information and limit any subjective interpretation that could promote double taxation.

The contractual terms of an agreement are an important consideration; however, paragraph 26 of the Issue Note seems to imply that recharacterization of a transaction would be relatively routine. We agree that when the substance of a transaction does not conform with its legal form, the tax authorities should have the ability to recharacterize the transaction. Having said that, in our experience MNEs often operate under an integrated model, with structures and transactions that would not always exist in an arm's length environment. Furthermore, even in an arm's length setting, parties frequently adopt a variety of structures based on each party's relative aversion to risk. The 1995 Guidelines support the recognition of transactions as structured. Clearly, arbitrary recharacterization of a transaction would have a significant impact on the relative profitability of an entity, and significantly increases the risk of double taxation. Guidance that promotes recharacterization as a routine matter leads to an environment of reduced certainty for taxpayers, and should be discouraged. Therefore, we recommend that any guidance reemphasize the importance of respecting the legal structure adopted by the taxpayer, the uniqueness of MNE operations, and the limited circumstances under which a tax authority may disregard the legal structure of a transaction.

#### **Issue Note: Selecting or Rejecting Third Parties or Third-Party Transactions: Degree of Objectivity of the List of External Comparables.**

Deloitte believes that any practical guidance on the issue of how to undertake a comparability analysis is a positive step. The objective of such analysis is clear -- to derive the best available data -- but the analysis must be a transparent, systematic, and repeatable process, whether the additive approach or the deductive approach is adopted. We note that the process may depend in part on the information sources used -- in North America databases tend to be comprised of public companies and provide more qualitative information, whereas European databases tend to contain more private companies and focus on quantitative aspects.

#### **Issue Note: Determination of and Making Comparability Adjustments When Appropriate**

Deloitte believes that taxpayers and tax authorities globally have historically invested a significant amount of time and money in searching for comparable transactions and making adjustments. Improving the reliability of the comparable information through comparability adjustments is a key consideration.

The concept that adjustments should be made only if the outcome improves comparability by improving reliability appears theoretically sound. Obviously, not knowing whether an adjustment improves the reliability of the outcome may simply be reflective of the lack of detail available on the comparable, and may not suggest that the unadjusted result is any more or less reliable. Given the practical limitations of the comparable information available, consistency in the application of transfer pricing rules would help to reduce the potential for double taxation. We therefore recommend that the Working Party provide further guidance regarding adjustments, in particular regarding the commonly used working capital adjustments, as well as accounting and geographic market adjustments.

#### **Issue Note: Multiple-Year Data**

Deloitte's experience is that arm's length parties often enter into long-term agreements and relationships. It seems logical to assume in those situations that arm's length parties would consider multiple years in determining an appropriate price. We acknowledge that multiple-year information may evidence a trend in a particular industry or product line. However, based on the practical limitations of data available, we suggest that, unless there is evidence that the comparables are, in fact, in a similar business and product cycle, one should not make that assumption subjectively. To the extent there is no evidence that the comparables are, in fact, in a similar business and product cycle, multiple-year data may often be a reasonable benchmark of arm's length profitability.

We concur that the suggested guidance outlined in paragraph 21 of the Issue Note would be helpful. However, with regard to the yearly assessment of taxpayer's results, Deloitte believes that the fact that a result for an individual year is outside the comparable range for that particular year should not suggest that it is non-arm's-length if the result is within the range for a longer period of time and there is limited, or no evidence that the comparables and the tested party are in the same business and product cycles. This highlights the problem that single-year or current-year data are often not available on a contemporaneous basis. It should also be noted that some tax jurisdictions may require that only a single year of taxpayer data be compared with multiple-year averages of comparable company data. This approach requires the even more difficult task of finding companies that are at the same stage of the business cycle as the tested party. Guidance from the Working Party addressing these aspects would be welcome.

#### **Issue Note: Aggregation of Transactions**

Deloitte agrees that there may be instances when, based on the independence of the transactions and the availability of information, a transactional approach may be the most appropriate method. However, we do not believe that a transactional approach should be assumed to be the most reliable in all cases. Many MNEs have very integrated operations whereby a variety of products and services are interdependent on one another within the overall business strategy. This interdependence often makes it difficult to create internal segmented financial statements without making significant assumptions regarding the revenue and expense allocations. Similarly, other MNEs at the same level would also be expected to have a complimentary mix of products and services. Independent parties which may be available as comparables that operate solely in either the product or the service side generally have a completely different business strategy and would not be directly comparable to the corresponding products or services within the MNE's overall business strategy. For this reason, the transactional approach often promotes disputes regarding the existing business strategies (e.g., loss leaders). Furthermore, there are the obvious limitations regarding the availability of comparable information at the transactional level. The reality is that, more often than not, aggregate transactions are a practical necessity in a transfer

pricing analysis. The Issue Note makes some statements that support this view. We would welcome inclusion of further guidance by the Working Party as to when aggregation may be used.

**Issue Note: Definition of the Arm's Length Range, Extreme Results, Methods to Enhance Reliability, Loss-Making Comparables**

Deloitte agrees that statistical methods should not be used as a substitute for comparability and an examination of the five comparability factors. Nonetheless, statistical methods are a useful tool in situations in which the only data available do not meet the theoretical standard of comparability. We would welcome additional guidance from the Working Party on the appropriate use of statistical methods.

As to the ranking of the points in the range, it is difficult to understand how comparables could be ranked without making fairly significant assumptions about the companies' operations. One would think that if the detail required to determine a ranking were available, one would be able to meet the theoretical standard of comparability.

We agree that financial results should not drive the selection process. Loss-making comparables should not be rejected simply because they are in a loss position, but may be rejected because the loss reflects a comparability issue. In this scenario, the business cycle of the tested party and the comparable companies should also be considered to ensure that the loss is not simply related to a low period in the business cycle. We agree that loss-making comparables should be considered individually.

**Issue Note: Documenting a Search for Comparables**

Deloitte supports the OECD's efforts to develop guidelines for supporting and documenting transfer pricing. Transfer pricing is a significant issue for MNEs and tax authorities, and guidelines would be useful to reduce misunderstandings and conflict between these two constituencies. If possible, it would be very useful to outline sample searches in common situations showing the scope of the search, acceptable screens, what adjustments should be made, and whether reconciliations are necessary.