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Dear Mr Owens

Proposed revision of Chapters I-III of the Transfer Pricing Guidelines

PricewaterhouseCoopers ('PwC') welcomes the opportunity to comment on the proposed revision of Chapters I-III of the Transfer Pricing Guidelines which was released on 9 September 2009. Our representations have been drawn up by a working party within PwC's global transfer pricing network.

PwC recognises the development in the clarity and coverage of Chapters I-III following the recent consultations on comparability and on transactional profits methods and we are grateful for the valuable efforts of the OECD in this area.

Our observations and comments follow.

1. Factors determining comparability -- Paragraphs 1.38 to 1.62

Our Comments:

Overall, we welcome this practical clarification of the application of the comparability factors and the considerations around the relative importance of each factor in the context of the nature of the transaction, the transfer pricing method adopted and the availability and reliability of data.

2. "In some cases, it has been argued that the relative lack of accuracy of the functional analysis of possible external comparables might be counterbalanced by the size of the sample of third party data; however quantity does not make up for poor quality of data in producing a reasonably reliable analysis" -- Paragraph 1.50

Our Comments:

We agree that quantity does not make up for quality and the text elsewhere in the revised Chapters I-III is helpful in explaining what reasonably reliable analysis is. However, as it stands this paragraph is removed from much of that other discussion and our concern is that it becomes a licence for tax auditors who wish to reject wholesale what may be perfectly legitimate attempts by taxpayers to apply the most reliable comparable data available to them in the circumstances. At the very least a reference to Para 3.2 (on "reasonably reliable comparables"), Para 3.37 (on the circumstances in which broader samples are useful) and Para 3.45 (selecting comparables) would be important to ensure this paragraph is not taken to mean more than is intended and not easily quoted out of context.

3.	**“The guidance at paragraph 2.1 that the selection of a transfer pricing method always aims at finding the most appropriate method for each particular case does not mean that all the transfer pricing methods should be analysed in depth or tested in each case in arriving at the selection of the most appropriate method. As a matter of good practice, the selection of the most appropriate method and comparables should be evidenced and can be part of a typical search process as proposed at paragraph 3.5.” -- Paragraph 2.7**

Our Comments:

We welcome the assurance that there is no requirement to undertake an in depth analysis of all methods in order to justify the selection of the most appropriate method.

4.	**Use of more than one method -- Paragraphs 2.10 and 2.11**

Our Comments:

We welcome the continued reassurance that the use of a second method as corroboration is not a requirement or expectation except in difficult cases, where no one method is conclusive and that the purpose of the secondary method is to identify whether the outcome from the primary method is unusual.

5.	**“A transactional profit split method may also be found to be the most appropriate method in cases where both parties to a transaction contribute unique and valuable assets (e.g. intangibles), because in such a case independent parties at arm’s length might wish to share the profits of the transaction in proportion to their respective contributions and a *two-sided* method might be more appropriate in these circumstances than a one-sided method.” -- Paragraph 2.63**

Our Comments:

The transactional profit split method can (and often does) include three or more parties, particularly in relation to global trading activities. In the current draft, the possibility of a multi-party profit split is not raised until paragraph 2.78. It would be helpful if the guidelines acknowledged explicitly at the outset of Chapter II Part III Section B that the transactional profit split method may involve more than two parties.

It would also be helpful if the OECD could clarify that profit split might also be appropriate where both parties perform highly specialised services. Paragraph 1.9 specifically raises the difficulty/complications in applying the arm’s length principle to specialised services without further comment in the remainder of the document.

6.	**"The determination of the combined profit to be split and of the splitting factors should generally be used consistently over the life-time of the arrangement, including during loss years, unless independent parties at arm’s length would have agreed otherwise and the rationale for using differing criteria or allocation keys is documented, or if specific circumstances would have justified a re-negotiation between independent parties." -- Paragraphs 2.71**

Our Comments:

We welcome the clarification that the profit split method should be applied consistently over the life-time of the arrangement.

It would be helpful to confirm that this principle also applies in reverse, such that if a party to a profit split method is to be insulated from losses (eg for regulatory reasons), then this limitation of risk should be recognised in the profit split during profitable years. This type of situation is often found in the financial services sector, for example, as is noted in paragraph 196 of the Report on the Attribution of Profits to Permanent Establishments (Part III).

7. The profit to be split. -- Paragraphs 2.78 to 2.80

Our Comments:

Although the reference in Paragraph 2.62 is simply to the "profit to be split", the terminology in Paragraphs 2.78-2.80 is of the "combined profit to be split" and the explanation in Paragraph 2.79 seems to make it clearer still that the OECD expects the profits of both parties to be combined.

We agree that the process of identifying the appropriate profit to be split is an important step in the analysis as set out in Paragraph 2.78. Part of that process is correctly described to be identifying the profit "arising from the controlled transaction(s) under review" – which may not, in fact, be combined if these profits all fall within one of the parties to the transaction.

There are cases where the only relevant transactional profits lie with one party and not both. One example is licensing of intellectual property where the split of the licensee's profits is often a useful way to corroborate or support CUP analysis which might not be conclusive on its own and may even be used as a primary method.

It would be helpful if the wording of Paragraphs 2.78-2.80 were amended slightly to remove the suggestion that the profit to be split is always that of at least two parties to the transaction(s).

8. "In order to determine the combined profit to be split, the accounts of the parties to the transaction to which a transactional profit split is applied need to be put on a common basis as to accounting practice and currency, and then combined." -- Paragraph 2.79

Our Comments:

Paragraph 2.79 is welcome clarification and confirmation of best practice. However, as noted above, the relevant profits may need to be combined or may not. Paragraph 2.79 would best serve as a description of what needs to be done if the profit to be split is a combined profit of more than one party.

9. Measures of profit. -- Paragraph 2.85

Our Comments:

Given the revised structure and additional detail provided in relation to the profit split method we consider that the reference to "contribution analysis" in Paragraph 2.85 applies to profit split in general and that the paragraph could usefully be updated to reflect this.

The material in Annex 1 provides helpful examples. However, there appear to be no references to Annex 1 in any part of the main text. We would recommend paragraph 2.85 as an appropriate point from which it might be referred.

10. Profit split allocation keys. -- Paragraphs 2.87 to 2.93

Our Comments:

Confirmation that one allocation key may be adequate is welcome. We also welcome the expansion and discussion of the types of allocation keys typically seen and the circumstances in which they are typically found. This is helpful without being prescriptive. We are also pleased to see acknowledgement that allocation keys can include an element of accumulation, where appropriate.

11. Transactional net margin method. -- Paragraph 2.101

Throughout most of the revised chapter the term “unique intangible” is helpfully and, in our view, correctly qualified either as “significant” (eg Para 2.3), “high value” (eg Para 2.62), “valuable” (eg Para 2.63) or “of significant value” (Para 2.75). Here the same term is used but without a qualifier in stating that the TNMM method is inapplicable when both parties possess “unique intangibles”. We consider that in the interests of both correctness and consistency it would be helpful to add one of the qualifiers used elsewhere.

12. Non-unique intangibles. -- Paragraph 2.102

Our Comments:

We welcome the acknowledgement that the presence of intangibles does not preclude the application of one-sided methods such as TNMM, provided the comparables can also be assumed to have equivalent intangibles.

13. Selection and determination of the net profit margin indicator. -- Paragraphs 2.118 to 2.142

Our Comments:

We welcome the helpful detail and discussion in Paragraphs 2.118-2.142, some of which is commented upon below.

14. Pass-through costs. -- Paragraphs 2.134 to 2.135

Our Comments:

We acknowledge the importance of differentiating between pass-through costs and external costs.

In our experience, the difficulties involved in evaluating the effect on comparable data can be considerable. There are examples where distinguishing the two types of costs has a material effect but these tend to be specific, are usually readily identified during the functional analysis process and can be dealt with by adjustments in either the comparable data (where it is reasonable to do so) or in the tested party. The example given in Chapter 7 is media buying.

In most cases, however, the effect of pass-through costs should have little or no material effect on the arm’s length range derived from comparable data and trying to make adjustments or find the data to make them may be impossible or represent a significant additional compliance burden.

Our experience is that in the majority of cases this issue does not give rise to controversy between taxpayers and tax authorities but in relatively few cases it does so. We are therefore concerned that as drafted these paragraphs, and paragraph 2.135 in particular, may lead to more rather than less controversy.

We consider that it would be helpful to do the following:

- to state one guiding principle which we believe is widely accepted – that one reason for excluding pass through costs from the mark up calculation on the tested party is to ensure that profit on a product or service that has been economically earned elsewhere is not double-counted;

- to include a reference to the principles set out in paragraphs 7.36 and 7.37 (marking up third party costs in the context of intragroup services); and

- to refer also to the principles set out in paragraphs 3.79-3.81:

15.	**“Where the indicator is a net profit weighted to assets, operating assets only should be used, excluding investments and cash balances.” -- Paragraph 2.137**

Our Comments:

Within the financial services sector, investments and cash balances are, more often than not, considered to be operating assets. A similar qualification to that used in paragraph 2.121 would help to qualify this paragraph.

16.	**Berry ratios. -- Paragraphs 2.140 to 2.142**

Our Comments:

We welcome the explicit recognition and discussion of the applicability of Berry ratios.

17.	**Comparability Analysis -- Chapter III**

Our Comments:

We welcome the inclusion of a chapter dedicated to the analysis of comparability, with a view to achieving more consistency of approach for both taxpayers and tax authorities. In particular we welcome the explanation provided of the term “reasonably reliable comparables” in Para 3.2.

Our concern is that the use of the superlative “most” in “most reliable comparables” in Para 3.2 will undo much of the benefit of these paragraphs as, however inaccessible or expensive the most reliable comparables may be, there can only be one set that meets this criterion even if it is unknown at the time. This exposes taxpayers to accusations of negligence or failure where they may have acted entirely reasonably. As currently drafted, the absolute test required by the use of “most” is then contradicted by the immediately following sentence in the same paragraph.

In the light of the clarification in Para 3.3 (that if better comparables should prove to have been available the tax authorities may still impose a tax adjustment) we consider that the word “most” is unnecessary and the OECD’s purpose in this paragraph would be achieved with a phrase such as “…the better of the comparables available in the circumstances of the case…” . This retains the requirement for evaluation and judgment without the suggestion that the taxpayer has failed to act properly if even better comparables should subsequently come to light.

18. "This does not mean that there is a requirement for an exhaustive search of all possible sources of comparables as it is acknowledged that there are limitations in availability of information and that searches for comparables data can be burdensome." – Paragraph 3.2

Our Comments:

We welcome this confirmation that perfect knowledge is neither available nor reasonably to be expected.

19. "This does not, however, imply a safe harbour. The fact that reasonable efforts have been made in finding and selecting comparables cannot rule out the possibility that more reliable comparables data may ultimately be found and used in determining an arm's length outcome." – Paragraph 3.3

Our Comments:

We recognise the intended purpose of this paragraph. However, our concern is that as drafted this paragraph may inadvertently validate the use of hindsight to allow tax authorities to re-price transactions based on information that the taxpayer could not reasonably have obtained nor have known at the time the transaction was entered into. Such an approach contradicts the underlying ex ante principle of attempting to replicate the behaviour by independent enterprises as set out in, for example, the first sentence of Paragraph 1.35 and the last sentence of Paragraph 3.68. It would be very helpful to clarify this paragraph to ensure this conclusion is not inadvertently drawn, perhaps by stating "…may ultimately be found **to have existed at the relevant time** and may then be used in determining…"

20. Information on the controlled transaction. -- Paragraph 3.20

Our Comments:

Paragraph 3.20 introduces a requirement that "some qualitative information" including functional analysis be made available on the (non-tested) counterparty to a transaction even when a traditional transfer pricing method such as cost plus or resale price is being used as well as when TNMM is applied. We agree, but consider it would be helpful to make it clear that the full analysis on which so much helpful explanation is now provided is not usually necessary.

In particular, we note that in an uncontrolled transaction none of the parties will be wholly ignorant of the functions of the other(s) – they will know, for example, where responsibilities lie and what is likely to be involved in carrying those out - but will not be party to the level of detail which might be expected or demanded by a tax administration.

It would be helpful if the OECD were to provide an indication that the phrase "some qualitative information" is intended to be limiting, in many cases at least, to the sort of information a party would have in an uncontrolled transaction of a similar nature.

21. No reason to request financial information of foreign related parties in the context of one-sided methods. -- Paragraph 3.22

Our Comments:

We welcome the clear statement that tax administrations generally have no reason to request financial data, nor the testing of profit level indicators of foreign related parties where a one-sided method is appropriate and the tested party is the domestic taxpayer.

22. Controlled transactions. -- Paragraph 3.25

Our Comments:

Paragraph 3.25 refers to "the risk assessment phase". This is a new term and this is the first and only time it is used (although risk assessment is also mentioned in Paragraph 3.81). We consider that the intention is to refer to an evaluation of the amount of tax that may be at stake either by the taxpayer (as suggested in Paragraph 3.81) or by a tax authority. If so, it may be more helpful simply to refer to such a process (eg "useful in evaluation of the potential amount of tax at stake") rather than to a phase of a procedure that is undefined.

23. Minority shareholders. -- Paragraph 3.26

Our Comments:

We agree with the helpful explanation provided in this paragraph but consider that a reference to the discussion in Paragraph 3.37 (on using the best data that is available) would help by putting this explanation in context.

24. Internal comparables. -- Paragraph 3.28

Our Comments:

We agree with the revised text on internal comparables but consider that the definitive conclusion to this paragraph ("will not be a valid comparable") sits ill with the approach in much of the rest of the revised Chapters I-III which is to make the best use of such data as is available in the most reliable way. It may be more consistent and more helpful to conclude in similar terms (eg "is unlikely to be a reasonably reliable comparable").

25. When a taxpayer intends to support its transfer prices with such a proprietary database, the tax administration may request access to the database for obvious transparency reasons." -- Paragraph 3.33

Our Comments:

The proposed revision has expressed certain concerns with respect to the coverage of data because databases may be based on a more limited portion of the market than commercial databases and because there may be a lack of transparency. However, this concern is not relevant for databases (ie software) which obtain data directly from one or more commercial data providers. There is no transparency issue in such cases as the same data is available to both the taxpayer and tax administration.

For the reasons given in the discussion on Paragraph 3.35 below, "reasonably reliable comparables" also means those for which the details are known and capable of challenge. If public data is being used this will always the case.

The OECD's recommendation should apply to proprietary data rather than databases in general.

26. Use of secret comparables -- Paragraph 3.35

Our Comments:

The edit to the text in Paragraph 3.35 (the old 3.30), which makes this applicable to all transfer pricing methods rather than just for the purposes of the TNMM, is welcome.

We consider that the analysis on pages 24-26 of the Draft Issues Notes released in 2006 and the results of the public consultation in November 2008 were sufficient to justify a stronger line against the use of secret comparables in the revised Chapters I-III. The analysis demonstrated that the use of secret comparables is not simply a matter of fairness but also of validity - in particular, that a so-called comparable which cannot be challenged on the basis of its comparability simply because the details are secret is inherently unreliable as the basis for applying an OECD transfer pricing method.

We note that in the revised Paragraph 3.34 it is stated that tax administrations can request access to proprietary databases “for obvious transparency reasons”. This is a less serious problem because while the databases may be proprietary, the detail and terms of the transactions or financial data provided are usually available. The same is not true in the case of a tax administration using secret comparables.

It is therefore unfortunate that the OECD has not been able to extend its criticism of the use of secret comparables beyond the statement that their use is unfair, when such data does not constitute “reasonably reliable comparable” data.

27. Broadening search strategies – Paragraph 3.37

Our Comments:

We welcome the recognition of the practical realities of finding and applying comparable data as set out in this paragraph.

28. Comparability adjustment - - Paragraphs 3.46 – 3.53

Our Comments on adjustment of the results of the tested party:

We welcome the additional explanations in terms of adjustments to comparable data and, in particular, the clear statement that these should not be routine or mandatory and should be made only where they improve the reliability of the results.

29. Statistical tools that take account of central tendency -- Paragraphs 3.56 and 3.61

Our Comments:

We welcome the confirmation in Paragraph 3.56 that the use of interquartile or other percentile ranges may help improve the reliability of the comparable data being applied.

However, in Paragraph 3.61 the same principle (to enhance reliability where “comparability defects remain”) is cited to support the use of a single point (the median, the mean or a weighted average) rather than the range. This is an expansion of the point in the old Para 1.48 where it was clear that this applied where the tax administration had demonstrated that the taxpayer had fallen outside the arm’s length range and that the taxpayer should be able to argue for a more appropriate point in the range. Now that the point is made in a separate paragraph of its own this is less clear and there is a risk that it might be used to counteract Paragraph 3.56.

This risk would be reduced if Paragraphs 3.60 and 3.61 were reintegrated.

30. "To the extent that it is possible to distinguish among the various points within the range, such adjustments should be made to the point within the range that best reflects the facts and circumstances of the particular controlled transaction -- Paragraph 3.60

Our Comments:

We welcome the continued confirmation that such consideration should be limited to the facts and circumstances of the controlled transaction. Specifically, this analysis should not be influenced by the performance of non-tested parties (including the wider group), thus ensuring consistency with the statements made in Paragraph 3.22 relating to inappropriate quantitative data requests. We consider that a specific reference to the application of Paragraph 3.22 in making the evaluation required in this paragraph would be helpful.

31. Timing issues in collection of data -- Paragraph 3.68 to 3.70

Our Comments:

We welcome the recognition of timing issues in relation to data but regret the fact that the text of these paragraphs seems limited to stating what is found in OECD member countries. The impression created is that the OECD is avoiding a conclusion in relation to these issues.

In addition, now that the "arm's length outcome-testing" approach has been described in the Guidelines it is surely necessary to recognise that this needs to have some limitations if hindsight is not to lead to situations where pricing fails to comply with the arm's length principle, particularly where the taxpayer has adopted and reasonably applied the "arm's length price-setting" approach.

A good example is where the taxpayer needs to price risk, such as for reinsurance or performance guarantees, the "arm's length outcome-testing approach" is either meaningless or it involves completely changing the nature of the transaction. The main points that would be relevant in these cases are addressed separately in Paragraphs 3.71 and 3.72.

We recommend that the wording of Paragraph 3.69 (on arm's length outcome-testing) contains a reference to Paragraphs 3.71 and 3.72 in order to ensure that the OECD is not inadvertently endorsing a retrospective approach to transfer pricing that is simply not arm's length.

32. Compliance issues -- Paragraphs 3.79 to 3.82

Our Comments:

We welcome the explicit consideration of the cost of compliance and the explanation this section provides to the "prudent business management principles" referred to in Para 5.4.

However, Paragraph 3.81 appears to be suggesting that comparables ought to be updated every year, even in the case of simple transactions undertaken in a stable environment where the transaction characteristics remain the same.

Until now it has generally been accepted in many countries that in straightforward and stable circumstances it is reasonable to update comparable data every 2-3 years particularly if multiple year data has been used in establishing the arm's length range (as recommended in the revised paragraphs immediately preceding these). The suggestion in Para 3.81 would therefore represent an increase in the compliance burden in such circumstances albeit that it seems to suggest that an update of the financial data alone is required. It is possible that the text is meant as an illustration in which case it would be helpful if this were made clear – or, if it is the intention of the OECD to impose an annual update requirement (of financials or the full analysis) that this be stated explicitly.

We welcome and support the work of the OECD to modernise and improve the Transfer Pricing Guidelines to reflect developments and the evolution of views since 1995 on the application of the arm's length principle.

Yours sincerely

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For clarification on any aspect of this response, please contact

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