



ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT



COMPARABILITY

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CENTRE FOR TAX POLICY AND ADMINISTRATION

COMPARABILITY

Introduction

1. Chapter I (paragraphs 1.33-1.79) and Chapter III of the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (hereafter the “TPG”) contain extensive guidance on comparability analyses for transfer pricing purposes. A revised version of this guidance was approved by the Council of the OECD on 22 July 2010 and can be downloaded from the Internet (see www.oecd.org/ctp/tp/cpm). All the references in this paper are references to the 2010 edition of the TPG.

2. The authoritative statement of the arm’s length principle is found in paragraph 1 of Article 9 of the OECD and UN Model Tax Conventions, which states:

“[Where] conditions are made or imposed between the two [associated] enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.”

3. This provision is the foundation for comparability analyses because it introduces the need for:

- A comparison between conditions (including prices, but not only prices) made or imposed between associated enterprises and those which would be made between independent enterprises, in order to determine whether a re-writing of the accounts for the purposes of calculating tax liabilities of associated enterprises is authorised under Article 9 of the OECD Model Tax Convention (see paragraph 2 of the Commentary on Article 9); and
- A determination of the profits which would have accrued at arm’s length, in order to determine the quantum of any re-writing of accounts.

4. It is important to put the issue of comparability into perspective in order to emphasise the need for an approach that is balanced in terms of, on the one hand, its reliability and, on the other, the burden it creates for taxpayers and tax administrations.

A. Significance of the comparability analysis and meaning of “comparable”

5. Application of the arm’s length principle is generally based on a comparison of the conditions in a controlled transaction with the conditions in transactions between independent

enterprises. In order for such comparisons to be useful, the economically relevant characteristics of the situations being compared must be sufficiently comparable.

A.1 What does “comparable” mean?

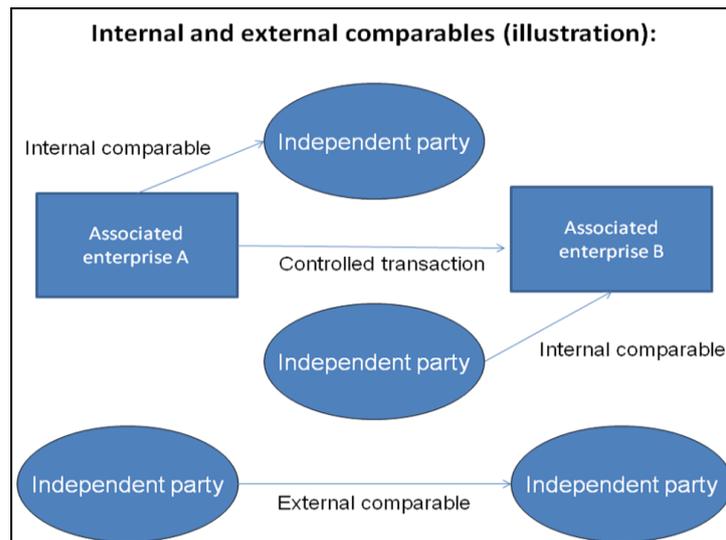
6. “Comparable” does not mean “identical”. To be comparable means that:

- None of the differences (if any) between the situations being compared could materially affect the price or financial indicator being examined in the selected transfer pricing method, or
- Reasonably accurate adjustments can be made to eliminate the effect of any such differences. These are called “comparability adjustments”.

7. Independent enterprises, when evaluating the terms of a potential transaction, will compare the transaction to the other options realistically available to them, and they will only enter into the transaction if they see no alternative that is clearly more attractive. For example, one enterprise is unlikely to accept a price offered for its product by an independent enterprise if it knows that other potential customers are willing to pay more under similar conditions. All methods that apply the arm’s length principle can be tied to the concept that independent enterprises consider the options available to them and in comparing one option to another they consider any differences between the options that would significantly affect their value. For instance, before purchasing a product at a given price, independent enterprises normally would be expected to consider whether they could buy the same product on otherwise comparable terms and conditions but at a lower price from another party.

A.2 Internal comparables and external comparables

8. A comparable uncontrolled transaction is a transaction between two independent parties that is comparable to the controlled transaction under examination. It can be either a comparable transaction between one party to the controlled transaction and an independent party (“internal comparable”) or between two independent enterprises, neither of which is a party to the controlled transaction (“external comparable”).



9. A common source of information on external comparables is commercial databases, which have been developed by editors who compile accounts filed by companies with the relevant administrative bodies and present them in an electronic format suitable for searches and statistical analysis. They can be a practical and sometimes cost-effective way of identifying external comparables and may provide the most reliable sources of information, depending on the facts and circumstances of the case.

10. A number of limitations to commercial databases are frequently identified. Because these commercial databases rely on publicly available information, they are not available in all countries, since not all countries have the same amount of publicly available information about their companies. Moreover, where they are available, they do not include the same type of information for all the companies operating in a given country because disclosure and filing requirements may differ depending on the legal form of the company and on whether or not it is listed. It is not always the case that commercial databases provide information that is detailed enough to support the chosen transfer pricing method. Not all databases include the same level of detail and can be used with similar assurance. Importantly, it is the experience in many countries that commercial databases are used to compare the results of companies rather than of transactions because third party transactional information is rarely available.

11. It may be unnecessary to use a commercial database if reliable information is available from other sources, *e.g.* internal comparables. Where they are used, commercial databases should be used in an objective manner and genuine attempts should be made to use the databases to identify reliable comparable information.

A.3 Can other controlled transactions be used as comparables?

12. Comparisons of a taxpayer's controlled transactions with other controlled transactions carried out by the same or another MNE group are irrelevant to the application of the arm's length principle and therefore should not be used by a tax administration as the basis for a transfer pricing adjustment or by a taxpayer to support its transfer pricing policy.

A.4 “Secret comparables”

13. Tax administrators may have information available to them from examinations of other taxpayers or from other sources of information that may not be disclosed to the taxpayer. However, it would be unfair to apply a transfer pricing method on the basis of such data unless the tax administration was able, within the limits of its domestic confidentiality requirements, to disclose such data to the taxpayer so that there would be an adequate opportunity for the taxpayer to defend its own position and to safeguard effective judicial control by the courts.

A.5 Cases where no comparables are found

14. Finding reliable comparables can be challenging in particular where:

- a) There are few public data available in the country on uncontrolled transactions (*e.g.* because there is no requirement for companies to file accounts with an administrative body which would make them public),
- b) There are no or few independent actors in a particular industry sector, *e.g.* due to vertical integration,
- c) The taxpayer engages in transactions that independent enterprises would not undertake. Such transactions may not necessarily be motivated by tax avoidance but may occur for instance because only large companies may be capable of undertaking them.

15. The arm’s length principle may become difficult to apply in these situations, because there is little or no direct evidence of conditions that have actually been established by independent enterprises in similar circumstances.

16. In case a) (lack of public data), it may be possible to use comparables data from other countries where more public information is available, subject to the markets being sufficiently comparable.

17. In case b) (lack of independent parties), it may be possible to use comparables data from other industries which are less integrated, subject to the conditions being sufficiently comparable to the ones in the taxpayer’s industry, or being capable of being adjusted in a reasonably accurate manner.

18. The most complex case is case c). The mere fact that a controlled transaction may not be found between independent parties does not of itself mean that it is not arm’s length. In such cases, lacking evidence of what independent parties *have actually done* in comparable circumstances, it becomes necessary to examine whether the conditions of the controlled transaction *would have been accepted* by independent parties in comparable circumstances. This is a delicate and more subjective exercise and one which should be approached with great caution in order not to create too much uncertainty for taxpayers and tax administrations.

19. A transactional profit split method might, in appropriate circumstances, be considered without comparable data, *e.g.* where the absence of comparable data is due to the presence of valuable, unique intangibles contributed by each party to the transaction. However, even in cases where comparable data are scarce and imperfect, the selection of the most appropriate transfer pricing method should be consistent with the functional analysis of the parties. Thus, a transactional profit split method would generally not be the most appropriate method for simple contract manufacturing activities where the manufacturer does not make any valuable, unique contribution in relation to the controlled transaction, even though only imperfect comparables may be found.

B. Factors determining comparability

20. As noted above, in making these comparisons, material differences between the compared transactions or enterprises should be taken into account. The TPG identify five “comparability factors” that may be important when determining comparability. These are:

1. The characteristics of the property or services transferred.
2. The functions performed by the parties (taking into account assets used and risks assumed), in relation to the controlled transaction. An examination thereof is often referred to as a “functional analysis”.
3. The contractual terms of the controlled transaction.
4. The economic circumstances of the parties.
5. The business strategies pursued by the parties in relation to the controlled transaction.

These five comparability factors are briefly discussed below, and in more detail in Chapter I (paragraphs 1.38 o 1.63) of the TPG.

21. As part of a comparison exercise, the examination of the five comparability factors is by nature two-fold, *i.e.* it includes an examination of the factors affecting the taxpayer’s controlled transactions and an examination of the factors affecting uncontrolled transactions.

22. The extent to which each of these factors matters in establishing comparability can vary on a case-by-case basis and will depend in particular on the nature of the controlled transaction and the transfer pricing method adopted. For instance, information on product characteristics might be more important if the method applied is a comparable uncontrolled price method than if it is a transactional net margin method. If it can be reasonably assumed that an unadjusted difference is not likely to have a material effect on the comparability, the uncontrolled transaction at issue should not be rejected as potentially comparable despite some pieces of information being missing.

B.1 Characteristics of property or services

23. Differences in the specific characteristics of property or services often account, at least in part, for differences in their value in the open market. Therefore, comparisons of these features may

be useful in determining the comparability of controlled and uncontrolled transactions. Characteristics that may be important to consider include the following:

- In the case of transfers of tangible property, the physical features of the property, its quality and reliability, and the availability and volume of supply;
- In the case of the provision of services, the nature and extent of the services; and
- In the case of intangible property, the form of transaction (*e.g.* licensing or sale), the type of property (*e.g.* patent, trademark, or know-how), the duration and degree of protection, and the anticipated benefits from the use of the property.

B.2 Functional analysis

24. In transactions between two independent enterprises, compensation usually will reflect the functions that each enterprise performs (taking into account assets used and risks assumed). Therefore, in determining whether controlled and uncontrolled transactions or entities are comparable, a functional analysis is necessary. This functional analysis seeks to identify and compare the economically significant activities and responsibilities undertaken, assets used and risks assumed by the parties to the transactions. For this purpose, it may be helpful to understand the structure and organisation of the group and how they influence the context in which the taxpayer operates. It will also be relevant to determine the legal rights and obligations of the taxpayer in performing its functions.

25. The functions that taxpayers and tax administrations might need to identify and compare include, *e.g.*, design, manufacturing, assembling, research and development, servicing, purchasing, distribution, marketing, advertising, transportation, financing and management.

26. The principal functions performed by the party under examination should be identified. Adjustments should be made for any material differences from the functions undertaken by any independent enterprises with which that party is being compared.

27. While one party may provide a large number of functions relative to that of the other party to the transaction, it is the economic significance of those functions in terms of their frequency, nature, and value to the respective parties to the transactions that is important.

28. The functional analysis should consider the type of assets used, such as plant and equipment, the use of valuable intangibles, financial assets, etc., and the nature of the assets used, such as the age, market value, location, property right protections available, etc.

29. Controlled and uncontrolled transactions and entities are not comparable if there are significant differences in the risks assumed for which appropriate adjustments cannot be made. Functional analysis is incomplete unless the material risks assumed by each party have been considered since the assumption or allocation of risks would influence the conditions of transactions between the associated enterprises. Usually, in the open market, the assumption of increased risk

would also be compensated by an increase in the expected return, although the actual return may or may not increase depending on the degree to which the risks are actually realised.

30. The types of risks to consider include market risks, such as input cost and output price fluctuations; risks of loss associated with the investment in and use of property, plant, and equipment; risks of the success or failure of investment in research and development; financial risks such as those caused by currency exchange rate and interest rate variability; credit risks; and so forth.

31. The functions carried out (taking into account the assets used and the risks assumed) will determine to some extent the allocation of risks between the parties, and therefore the conditions each party would expect in arm's length transactions. For example, when a distributor takes on responsibility for marketing and advertising by risking its own resources in these activities, its expected return from the activity would usually be commensurately higher and the conditions of the transaction would be different from when the distributor acts merely as an agent, being reimbursed for its costs and receiving the income appropriate to that activity. Similarly, a contract manufacturer or a contract research provider that takes on no significant risk would usually expect a lower return than if it were assuming such risks.

B.3 Contractual terms

32. In arm's length transactions, the contractual terms of a transaction generally define explicitly or implicitly how the responsibilities, risks and benefits are to be divided between the parties. As such, an analysis of contractual terms should be a part of the functional analysis discussed above.

33. The terms of a transaction may also be found in correspondence/communications between the parties other than a written contract. Where no written terms exist, the contractual relationships of the parties must be deduced from their conduct and the economic principles that generally govern relationships between independent enterprises.

34. In transactions between independent enterprises, the divergence of interests between the parties ensures that they will ordinarily seek to hold each other to the terms of the contract, and that contractual terms will be ignored or modified after the fact generally only if it is in the interests of both parties. The same divergence of interests may not exist in the case of associated enterprises, and it is therefore important to examine whether the conduct of the parties conforms to the terms of the contract or whether the parties' conduct indicates that the contractual terms have not been followed or are a sham. In such cases, further analysis is required to determine the true terms of the transaction.

35. In practice, information concerning the contractual terms of potentially comparable uncontrolled transactions may be either limited or unavailable, particularly where external comparables provide the basis for the analysis. The effect of deficiencies in information in establishing comparability will differ depending on the type of transaction being examined and the transfer pricing method applied. For instance, if the controlled transaction is a licence agreement for the exploitation of intellectual property rights and the transfer pricing method is the comparable uncontrolled price method, information on the key contractual terms of uncontrolled licences, such as the licence's

duration, geographic area, exclusivity, etc., can be assumed to be critical to assessing whether such uncontrolled licences provide reliable comparables for the controlled transaction.

B.4 Economic circumstances

36. Arm's length prices may vary across different markets even for transactions involving the same property or services; therefore, to achieve comparability requires that the markets in which the independent and associated enterprises operate do not have differences that have a material effect on price or that appropriate adjustments can be made.

37. Economic circumstances that may be relevant to determining market comparability include the geographic 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 as a whole and in particular regions, if relevant; consumer purchasing power; the nature and extent of government regulation of 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.

38. The facts and circumstances of the particular case will determine whether differences in economic circumstances have a material effect on price and whether reasonably accurate adjustments can be made to eliminate the effects of such differences.

B.5 Business strategies

39. Business strategies must also be examined in determining comparability for transfer pricing purposes. Business strategies would take into account many aspects of an enterprise, such as innovation and new product development, degree of diversification, risk aversion, assessment of political changes, input of existing and planned labour laws, duration of arrangements, and other factors bearing upon the daily conduct of business. Such business strategies may need to be taken into account when determining the comparability of controlled and uncontrolled transactions and enterprises.

40. Business strategies also could include market penetration schemes. A taxpayer seeking to penetrate a market or to increase its market share might temporarily charge a price for its product that is lower than the price charged for otherwise comparable products in the same market. Furthermore, a taxpayer seeking to enter a new market or expand (or defend) its market share might temporarily incur higher costs (*e.g.* due to start-up costs or increased marketing efforts) and hence achieve lower profit levels than other taxpayers operating in the same market.