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

Is this a real issue? *Yes.*
Is this an important issue? *Yes.*
What is your experience with the issue?

In the majority of transfer pricing analyses, transaction-level data is either not publicly available or not comparable. Therefore, practitioners are left with no option but to rely on company-level public information which, by definition, is an aggregation of individual transactions. Generally, transaction-level data will converge with company-level data the more closely the comparable companies match the subject entity in the controlled transaction.

Typically, comparable companies are selected by evaluating a sample of potential comparables and selecting those that are the closest to the controlled transactions based on the relevant factors, which include functions, risks, products, markets, and geographic comparability. One could assume that transactions between unrelated parties are conducted in a manner where, on average, the participants expect to realize a margin within some target range. Any individual transaction may be priced in a way that will lead to higher or lower margins than the target range, but on average, under 'normal' circumstances, the target range is achieved. These margins aggregate at a company-level, providing a measure of margins earned over a period of time between unrelated parties. Therefore, the major assumption made when using aggregate information to determine the arm's-length nature of controlled transactions is that the company-level profits or margins are, in total, representative of arm's-length transactions.

More often than not, comparable companies are inexact comparables based on the search strategy. In such instances, the method selected will have an impact on the usefulness of company-level data. For example, the gross profit-based or traditional methods are far more sensitive to differences between company-level and transactional data than operating profit-based methods when comparables are inexact. Therefore, results using company-level data would more likely diverge from results using transaction-level data under gross profit-based methods. Valuing specialized activities, such as R&D, as opposed to broader 'distribution' functions would also tend to cause divergence between the transaction and company-level data if comparable companies are not equally specialized.

To the extent that comparables are selected carefully and appropriately, margins from company-level data can be used to benchmark margins earned in uncontrolled transactions.

Any suggestions for improving the 1995 transfer pricing guidelines with respect to the issue?

The Guidelines should acknowledge the reality of the lack of transaction-level data in a majority of cases. Explicit guidance on this subject needs to be coordinated with comparability guidelines to ensure that the divergence between transaction and company-level data is minimized. Most practitioners look for transaction-level data before company-level data, a process that should be elaborated in the Guidelines to ensure that company-level data could be used only if transaction-level data is unavailable or unreliable.

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

Is this a real issue? Yes
Is this an important issue? Yes
What is your experience with the issue?

In evaluating public information on 'listed' and private companies, practitioners can come across information, including the unconsolidated financial statements, of the affiliates of MNEs. This type of data is most frequently encountered in Europe, where statutory reporting requirements in several countries make private company information publicly available. To a lesser extent, data from 'listed' companies within MNE Groups is also available in some countries. For example, Hindustan Lever Limited (India), a 51% owned subsidiary of Unilever PLC reports financial statements that reflect intercompany license payments.

To reliably use data on third-party enterprises that are part of an MNE group as comparable data, one must assume that the data reflects arm's-length dealings between the related parties. In practice, it is almost impossible to verify that is the case. Even when the data is from public companies, which ostensibly are held to higher reporting requirements, it may not be possible to ascertain the full nature of dealings between affiliated companies. In some instances, segmented data from the above sources that is clearly between unrelated parties may be useful if all other comparability criteria are met. In practice, however, lack of detailed segmented public data make it very difficult to verify that the data from the above sources are reliable and reflect arm's-length transactions.

While rejection of unconsolidated affiliates of MNEs may systematically exclude the extremely remote possibility of locating useful unrelated transaction data, the cost required to verify the arm's-length nature of the above data sources, and making any necessary comparability adjustments (as would likely be the case) would be prohibitively high.

Any suggestions for improving the 1995 transfer pricing guidelines with respect to the issue?

The Guidelines should help taxpayers understand the narrow circumstances when data from unconsolidated affiliates of MNEs could be used, and the conditions under which they would provide a reliable measure of an arm's-length result.

Issue: COMP 3 - Need to obtain third party information relevant to the review of the five comparability factors
Is this a real issue? Yes
Is this an important issue? Yes
What is your experience with the issue?

Practitioners typically face a myriad of challenges assessing the usefulness of uncontrolled comparables in terms of the five factors. Before considering the five factors specifically, several general concerns need to be discussed. First, the dual nature of publicly-available filings, that is disclosing business and financial information as well as promoting the company to current and potential shareholders, suggests that close scrutiny of the filing is needed. Secondly, inconsistency in the volume and quality of publicly-available information from country to country, and even company to company, often makes the global application of a consistently search strategy (e.g., consistent application of the accept/reject criteria) impractical, if not impossible. These concerns, along with other specific issues, are addressed for each of the five factors below:

Characteristics of Property or Services - General information regarding the nature of a company's business or products is typically readily available. However, it is often difficult to determine the relative quality and value of a product or service based on the description of company filings, websites, or other publicly available information. Practitioners commonly cope with this dilemma by performing general industry research based on third-party industry publications, newsletters, and websites. In addition, interviews with the taxpayer's industry expert (working outside of the tax department) often shed light on technology, product, and marketing trends.

Functional Analysis - In most cases, the comparable's primary function is easily identified. It may be more difficult to ascertain, though, the relative importance of other functions, risks, and intangibles to the overall profitability of an uncontrolled entity's business. For example, an uncontrolled manufacturer often lists design, sales, and research and development as additional value-adding activities. Based on publicly-available information, it is often difficult to determine if sales activities, for example, are simply managing customer relationship or involve strategic and complicated advertising and marketing activities. Furthermore, it is often difficult to determine the relative value of intangible property to the profitability of the firm. For example, many companies in the apparel industry have a brand or trademark. Some of these marks are valuable and well developed while others are not. Analysts must utilize their knowledge of the market to determine what drives value in any given industry. Furthermore, they should account for such differences through financial adjustments aimed at removing costs and profits from ancillary functions and focusing on the profitability of core activities.

Contractual Terms – When analyzing intercompany licenses or service arrangements using comparable agreements (such as intellectual property licenses and purchasing agent agreements), contractual terms are often laid out. However, when conducting analyses based on comparable companies (see COMP 1 on the use of company-level data), the taxpayer or practitioner often has to extrapolate contractual terms using reported financial data. For example, if a comparable distributor reports, on average, 45 days of receivables (based on the average accounts receivable to sales ratio), one generally assumes that all sales are made at this term. However, it is more likely that some transactions have shorter days outstanding while other customers are given longer to pay.

Economic Circumstances – Industry information is usually available, unless an industry being analyzed is in its infancy. Such information can be used to make certain assumptions about the general economic conditions affecting participants in the industry. However, information on particular markets and characteristics of those markets – particularly for new or developing markets or industries – are often less readily available. For that reason, the selection of comparable companies or transactions often involves making certain assumptions about level of the market, local competition, etc. For that reason, the analysis of the relative industry and market tend to be of a general, rather than specific, nature.

Business Strategies – It is rare that taxpayers are able to find reliable information regarding the strategies that a potentially comparable company employs. It seems unlikely that any MNE would publish its overall business strategy (in any reliable detail) in publicly-available documents. Independent analyst reports remain the best method for retrieving this type of information.

Any suggestions for improving the 1995 Transfer Pricing Guidelines with respect to the issue

It is difficult to fulfill the comparability requirements as outlined by the Guidelines due to the inconsistent volume and quality of data available from country to country. However, changes to the Guidelines should be made to specifically recognize financial adjustments that take into account the costs and profitability associated with ancillary functions, risks, and intangibles. In addition, the Guidelines should more specifically discuss the application of the arm's-length range when comparing the functions of the related party with the activities of the comparables.

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

Is this a real issue? Yes
Is this an important issue? Yes
What is your experience with the issue?

Defining "cherry-picking" as the design and/or selection of the comparable search strategy to obtain a specific result, it would be desirable, yet extremely difficult (within the practical limitations of the Guidelines), to ensure that potentially relevant external comparables are not excluded because of the application of a too drastic comparability standard. The specificity regarding the application of the comparability standards for any given project is determined by several factors, including the availability and quality of information, the industry that is associated with the analysis, the manageability of the available strategy options, and the activities of the taxpayer. When devising a strategy to locate comparable companies, practitioners typically summarize the functional analysis in terms of key functions, risks, and intangibles. Based on the size of the industry, the relative uniformity of the companies within the industry, and the prevailing economic conditions, the research strategy may become more judgmental or forgiving. Rather, a level of uniformity among the comparables that best captures the nature of the related party's business is sought.

Any suggestions for improving the 1995 Transfer Pricing Guidelines with respect to the issue

Clearer or more specific research strategy documentation standards would further discourage cherry-picking. In addition, it should be noted that the employment of a statistical analysis of the range of results (as discussed in COMP 8 below) would tend to eliminate outliers, resulting in the additional benefit of limiting cherry-picking within the range of results.

The resolution of this issue resides to a large extent in the enforcement of the comparability standards rather than updating the Guidelines. Very few options (short of mandating the review of every public and private company) exist for regulating the consistent identification of comparables without limiting one's ability to produce the most reliable analysis. Modifications to the Guidelines would be useful to the extent that they provide practical advice to tax authorities concerning the consistent enforcement of Guidelines-based regulations.

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

Is this a real issue? Yes

Is this an important issue? Yes
What is your experience with the issue?

Multiple year analyses and the use of third party information leads to a number of issues that can be problematic for the taxpayer. Tax authorities generally suggest the use of a multiple year analysis. Often, this is implicitly taken to mean the analysis of the most recent year and the two years before that. However, it may be (as the Transfer Pricing Guidelines state) more appropriate to consider the year under review and the year(s) before and after that year.

There are benefits to using a multiple-year analysis. For one, it may help to smooth business cycle issues—by putting less emphasis on a single year. The use of multiple year averages may also help to minimize the impact of using non-contemporaneous data (see database issues addressed in COMP 6 below). However, such a rational for use of a multiple year analysis may be most appropriate when analyzing transactions between affiliated companies in relatively stable industries. To the extent that non-contemporaneous data must be used to analyze a transaction in a more volatile context, it may be appropriate to consider the use of a comparability adjustment (see COMP 7 below).

Sometimes, a company may find itself in a position that a retroactive adjustment to its transfer prices would be necessary to more accurately reflect prices that are consistent with the arm's-length standard. Such adjustments are difficult to make in the best of circumstances. Many companies are unwilling and oftentimes unable to make a retroactive adjustments to their transfer prices. In France, in particular, the practice seems taboo, while in the United States, any such adjustments made after the end of the fiscal year are met with a great deal of scrutiny and suspicion on the part of the taxing authority despite a seeming mandate in the regulations to make such adjustments. In addition, retroactive adjustments make the use of multiple year analyses practically compulsory. Unless one uses a multiple year analysis, the adjustment will have a much greater impact on the determination of the arm's-length result in one year to the detriment of other years.

Any suggestions for improving the 1995 Transfer Pricing Guidelines with respect to the issue

A clearer definition of the appropriate years to use in a multiple year analysis (i.e., number of years, use of most recent year and those before the most recent year, analysis of the year under review and year(s) before and after the year under review) would be helpful for the taxpayer and the practitioner. Likewise, guidance on when one could deviate from these norms due to industry or company conditions would be appreciated.

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

Is this a real issue? Yes
Is this an important issue? Yes
What is your experience with the issue?

In the United States, publicly-traded companies are generally required to file financial data within three months of the end of their fiscal year. Coupled with the contemporaneous documentation standard (under which a taxpayer would generally have to complete its transfer pricing documentation within nine months of the end of the fiscal year), financial data from publicly available sources in the United States is generally available to be utilized in the preparation of contemporaneous documentation. This information is available in commercial databases in a format that facilitates analysis by taxpayers or practitioners. In addition, there is a great deal of information available about U.S. publicly-traded companies through the Securities and Exchange Commission.

When employing comparable data from companies headquartered outside of the United States, the data limitations are more severe. While there are commercially available databases that publish information on non-U.S. public and private companies, generally speaking, the information for those companies tends not to become available until at least one year after the end of the fiscal year. When analyzing comparable data from Europe, Asia, or Latin America, the comparable data will almost always be at least one year behind the year(s) that is (are) under review.

When planning for changes to transfer prices, the issue of data availability is more problematic. Companies sometimes attempt to use their own quarterly or plan data to manage the transfer pricing implementation process. That data is occasionally combined with quarterly data available for the comparable companies. In the United States, data reported quarterly is not subject to the same accuracy requirements as that reported in an annual filing. The issues associated with comparable company data that exist for non-US comparables are exacerbated when one is engaged in a planning project – often the data being used is several years removed from the years for which the taxpayer is attempting to set its transfer prices. It is relatively common for companies to resort to the use of non-contemporaneous data when setting or documenting their transfer prices in these instances. To some extent, the shortfalls of using historical data can be addressed through the use of quarterly data and/or by analyzing multiple year results (see COMP 5).

Any suggestions for improving the 1995 Transfer Pricing Guidelines with respect to the issue

There has been considerable news recently about the use of so-called "secret" comparables by some tax authorities. To some extent, the use of such data is a response by these tax authorities to the lack of publicly-available data. It cannot be over emphasized, however, that as this information is only available to one party in a transfer pricing controversy situation, the use of such information is unfair. The Guidelines should specifically reiterate the need to use only information that is publicly available (assuming there are not internal transactions that can be used in the analysis) so as to ensure that all parties have access to the same information.

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

Is this a real issue? Yes
Is this an important issue? Yes
What is your (our) experience with the issue?

The arm's-length standard requires that affiliated companies price their intercompany transactions as if the companies were unaffiliated but that all other facts and circumstances were unchanged. Stated differently, affiliated companies are free to choose how to structure their intercompany transactions – keeping in mind the requirement that the transactions have economic substance – as long as they price those transactions according to market principles. They are not required to conform the structure of their transactions to already existing market structures. As a result, there are many instances where intercompany transactions simply have no exact comparable.

Limited-risk structures, such as contract service arrangements in which an affiliated entity's profits are guaranteed, are prime examples of such arrangements. Adjustments to existing, unaffiliated transactions are absolutely required if the transfer pricing policy is going to conform to the arm's-length standard in such structures. Highly sophisticated adjustments are required, but can be reasonably made using existing economic and finance techniques. Other more common examples of differences between affiliated and unaffiliated transactions include terms of trade, inventory levels, warranty terms, and the like. Methods to adjust for these various factors often differ across practitioners, although the differences between adjustments for the most common factors (e.g., terms of trade or working capital) do not typically produce materially different transfer prices. The data required for such adjustments are generally available from the financial data reported publicly for most companies. Adjustment methods for less common factors (e.g., contract service arrangements, foreign exchange risk, etc.) are less established and, thus, vary considerably across practitioners and fiscal authorities.

In short, differences in comparability factors can have a material difference on the arm's-length price and, most importantly, are present in almost every intercompany pricing analysis. As a result, adjusting for such factors is absolutely required if transfer prices are to conform to the arm's-length standard. Nevertheless, several fiscal authorities simply refuse to accept any such adjustments on the premise that if the comparables were truly comparable, no adjustments would be required.

Any suggestions for improving the 1995 Transfer Pricing Guidelines with respect to the issue:

First, the OECD Guidelines should make even more explicit the recognition that application of the arm's-length standard will often lead to material differences between affiliated and unaffiliated transactions and that in such cases, adjustments to available comparables will be required. Second, it would be helpful if the Guidelines were to provide some specific examples of suitable adjustments, particularly for the most common factors such as terms of trade, warranty conditions, etc., and the conditions under which such adjustments were permissible, if not encouraged or required.

Issue: COMP 8 - Interpretation and use of data collected

Should the answers to these questions be different depending on the "quality" of the comparables (e.g. in cases where a less stringent comparability standard would be applied by a taxpayer operating in a highly integrated business where it is very difficult to find independent comparables that fully satisfy the existing comparability standard)?

Is this a real issue? Yes

Is this an important issue? Yes

What is your experience with the issue?

Using the language of statistics, a set of comparables that is used to establish an arm's-length range is a sample of all of the potentially comparable, unaffiliated transactions in the market. It is a sample because many, if not most, of the potential comparables cannot be observed (i.e., private company data, non-disclosed license agreements, etc.). This sample is then used to test the hypothesis that a particular transfer price satisfies the arm's-length standard. Application of statistical theory dictates that the results of such a test be stated in terms of a "confidence level" which directly corresponds to the likelihood that the transfer price falls within a range of results predicted by the observed sample. That is, the sample is used to predict the behavior or range of the total population – the sample is not, except in rare circumstances, considered to be the population itself. The confidence level and hypothesis test are constructed using variance and other common statistical concepts. These concepts have the effect of narrowing the range based on variations of the observed data from the average result and some assumptions about the characteristics of the population. By extension, use of a set of comparables to test whether a transfer price satisfies the arm's-length standard requires the use of some statistical measure. Such measures, whether based on a statistically meaningful measure of variance or the more simplistic "interquartile" calculation, have the effect of eliminating the extreme ends of the observed range. If we accept the premise that the observed set of "comparables" is but a sample of the broader set or population of comparable, but unobservable, transactions, then we must use such a technique if we are to achieve a meaningful test of an arm's-length result. One exception to this conclusion arises when the comparables are of such high quality that the practitioner determines that the population is adequately represented without the use of some statistical measure.

Statistical theory generally assumes, however, that we have a large number of observations and that the characteristics of their distribution are known. Neither assumption is generally valid in the context of intercompany analysis. Practitioners typically have a very limited number of observable transactions and assume a normal distribution out of habit, rather than statistical analysis. As a result, calculation of a variance is often meaningless. In such instances, analysts typically resort to a simple “interquartile” analysis out of statistical necessity. Faced with such limitations, some practitioners take a financial market approach to the selection and analysis of comparables, abandoning construction of the arm’s-length range based on functional comparability. This approach, which looks to return on equity or capital employed, admits many, many more companies as (financial market) comparables and allows for, and in fact requires, the application of various statistical techniques to narrow the range.

With respect to loss companies, such companies should generally be admitted to the set of comparables for purposes of testing an arm's-length result if it can be shown that the losses are temporary and not indicative of a non-viable company. That is, most, if not all, companies experience losses at some point in their history. Losses are a normal part of business; therefore, companies should not be automatically excluded from consideration because of losses. Nevertheless, loss companies that are under bankruptcy protection, for instance, should not be admitted to the comparable set, as their losses are not occurring under normal operating conditions. A careful examination of the potentially comparable companies should be able to identify such special circumstances for companies that are publicly traded in the United States. For non-U.S. companies, it may be more difficult to determine if the company faces such unusual conditions.

Any suggestions for improving the 1995 Transfer Pricing Guidelines with respect to the issue:
It would be helpful to provide additional guidance on the proper use of statistical techniques, namely, that such techniques are required to ensure a meaningful (statistical) test of an arm’s-length result.

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

Is this a real issue? Yes
Is this an important issue? Yes

What is your experience with the issue?

Due to limited availability of data on unaffiliated entities, the transactional net margin method (TNMM) can generally only be applied on an entity level, as opposed to a transaction level, basis. This limitation should not be viewed as a problem with the method; rather, practical considerations typically override its strict application (see COMP 1). That having been said, the TNMM is generally less sensitive to differences in certain accounting standards than are the traditional methods (e.g., cost plus and resale price). Specifically, the TNMM is immune to accounting uncertainties created by questions related to whether certain expenses are reported in cost of goods sold or operating expenses. For instance, some companies report depreciation in cost of goods sold, while others report depreciation in operating expenses (i.e., below gross margin). Problems arise when companies provide insufficient detail on their accounting treatment of such expenses. In such cases, it is impossible to make the necessary accounting adjustments to correct the traditional methods for reporting differences. It is, therefore, necessary to use the TNMM as it measures profitability after having taken account of all expenses whether they are reported above or below gross margin. The TNMM is, however, not superior to the traditional methods with respect to handling differences in accounting methods. Continuing the depreciation example from above, if the difference in depreciation is not related to where the expense is reported but to the depreciation method itself (e.g., straight-line versus accelerated depreciation), adjustments would have to be made to traditional methods and the TNMM alike.

With respect to product or functional differences, the TNMM is less sensitive than the traditional methods to the extent that such differences can be directly translated into differences in expense levels as opposed to underlying differences in profit potential. For instance, if an affiliated distributor provides a higher level of service than the comparables, as implied by the functional analysis and measured by a higher level of operating expenses to sales compared to unaffiliated distributors, then the TNMM will automatically adjust for this difference as it will take into account the actual expense level of the affiliated party. (It should be noted that any attempt to adjust the traditional methods for differences in the overall level of operating expenses implicitly converts the traditional method into a TNMM.) The TNMM implicitly assigns the same return to the additional services performed as it assigns to the rest of the operation. If the analyst has reason to believe that the additional services should earn a different return than the rest of the operation, the TNMM will not properly adjust for the difference. Similarly, if the additional services would cause the entire operation to earn a different return, then the TNMM will not properly adjust for the difference. In the extreme, some practitioners take a financial markets approach and will only use a return on assets or capital employed TNMM as financial markets are supposed to bid away differences in risk adjusted returns regardless of product or functional differences.

Regarding the application of transactional profit split methods, it is nearly impossible to find data on the actual profit splits achieved by third parties. There are some data available on profit splits between unrelated parties involving very specific circumstances. For example, in the franchising world, information is available on the split of franchise fees (which can be thought of as analogous to gross profits) between franchisors and master franchisors. In addition, data on joint ventures can provide some indication of profit splits. The franchising application is very specified and it is difficult to generalize from joint venture profit splits due to their highly idiosyncratic characteristics. Therefore, while either of these data sources may be useful in very particular contexts, they are not practical for general use.

The use of profit splits based on internal data is a viable option when external data are not available for certain types of intercompany arrangements. For instance, when two entities are jointly involved in the development of a bundle of intangibles, it would be unlikely that any third party data on the proper split of profits would be available. Thus, a profit split method would generally be appropriate. Moreover, the calculation of a profit split can often provide a good test of reasonableness for other pricing methods. Such calculations, however, are most appropriately thought of “sanity checks” or “test of reasonableness” as opposed to actual pricing methods.

Any suggestions for improving the 1995 Transfer Pricing Guidelines with respect to the issue:
In conjunction with the discussion of adjustments (see COMP 8), it would be helpful to include in that discussion some guidance as to which methods are most appropriate given certain circumstances, such as adjustments for functional differences, selection of profitability measure (e.g., return on sales versus assets), etc.