MDW CONSULTING INC.
TRANSFER PRICING EXPERTS

9 September 2013

Mr. Joseph L. Andrus
Head of Transfer Pricing Unit
Centre for Tax Policy and Administration
Organisation for Economic Co-Operation and Development
2, rue André Pascal
75775 Paris Cedex 16
France

Re: Revised Discussion Draft on Transfer Pricing Aspects of Intangibles, issued on 30 July 2013

Dear Mr. Andrus,

I am pleased to respond to the OECD's request for comments. I share your interest in building consensus among the OECD member countries and other participating countries. Respectfully, the attached comments are provided with the best intentions to help with this difficult process.

I am a Chartered Accountant and Chartered Business Valuator who has specialized in transfer pricing since 1996. My career and practice at MDW Consulting Inc. regularly deals with intangibles, business restructuring and other transactions. I have appeared in the Tax Court of Canada as a transfer pricing expert in *Alberta Printed Circuits Ltd. v. The Queen*, which dealt with these issues and concerns. MDW is a member of the Altus Alliance, an international association of transfer pricing professionals.

Please contact me should you wish to discuss my comments in further detail. I am available and interested in attending the public consultation to be held on 12 - 13 November 2013.

Sincerely,

Matthew Wall

Matthew Wall CA CBV

Cc: Ms. Michelle Levac, Chair of Working Party No. 6 and of its
Special Session on the Transfer Pricing Aspects of Intangibles

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Comments are provided for the selected topics listed below, which refer to the discussion draft for Chapter VI on Intangibles issued on 6 June 2012 ("2012 Draft"), the revised draft issued on 30 July 2013 ("2013 Draft"), and the final version to be issued at a future date ("Final Version").

Chapter VI: Special Considerations for Intangible Property

Appendix

Wall, M. and Jarcyzk, D., "Tax authorities using CUPs for pricing transactions", TP Week (March 2013).

Legal vs. Economic Ownership of Intangibles

Interpretation

Part B refers to the legal owner and economic owner of intangibles, although the 2013 Draft replaces "economic ownership" in Chapter VI of the OECD Guidelines with "the parties performing functions, using assets, and assuming risks related to developing, enhancing, maintaining and protecting intangibles".

Paragraph 71 begins by recognizing the legal owner as the sole owner of intangibles:

> 71. When the relevant registrations and contractual arrangements are consistent with the conduct of the parties (as discussed in paragraph 1.53), the legal owner will generally be considered the sole owner of the intangible …

However, in the absence of a legal owner, paragraph 71 recognizes the economic owner:

> 71. … If no legal owner of the intangible is identified … then the member of the MNE group which, based on the facts and circumstances, controls decisions concerning the use and transfer of the intangible and has the practical capacity to restrict others from using the intangible will be considered the legal owner.

The controversy begins in paragraph 73 when it diminishes the relevance of legal ownership:

> 73. The question of legal ownership is separate from the question of remuneration under the arm's length principle. It is important to note that, for transfer pricing work purposes, legal ownership of intangibles, by itself, does not confer any right ultimately to retain any return from exploiting the intangible …

The controversy continues in paragraph 73 when it favors economic ownership, saying the legal owner must also be the economic owner, or risk losing some or all of the intangible profits:

> 73. … The return ultimately retained by the legal owner depends upon the contributions it makes to the anticipated value of the intangibles through its functions performed, assets used, and risks assumed … where the legal owner makes no contributions that are anticipated to enhance the value of the intangible, the legal owner will not ultimately be entitled to retain any portion of the return attributable to the intangible …

It appears the 2013 Draft guidance for "economic ownership" of intangibles is similar to, if not the same as, the notion of "beneficial ownership".[1] For example, in discussing beneficial ownership and the denial of tax benefits for conduit companies, paragraph 14(b) of the OECD Conduit Companies Report (1986) states:

> The provisions would, however, apply also to other cases where a person enters into contracts or takes over obligations under which he has **similar functions to those of a nominee or agent. Thus a conduit company can normally not be regarded as the beneficial owner if**, though the formal owner of certain assets**, it has very narrow powers which render it a mere fiduciary or an administrator acting on account of the interested parties** (most likely the shareholders of the conduit company). [Emphasis added in bold.]

[1] The Dictionary of Canadian Law, Second Edition defines "beneficial owner" in part as the real owner of the property even though it is in someone else's name. This is similar to, if not the same as, "economic owner" described in Part B and Examples 1, 2 and 3 of the 2013 Draft.

If I understand the above correctly, it appears paragraph 73 in the 2013 Draft and certain Examples would permit a tax authority to reassess a taxpayer if the taxpayer enters into contracts or takes over obligations under which it has similar functions to those of a nominee or agent. Although the taxpayer is the legal owner of intangibles, the taxpayer is not regarded as the economic owner if it has very narrow powers which render it as a mere fiduciary or an administrator for a related party (e.g., parent company).

Example 3 supports this interpretation, where Company S is the legal owner of the patents, but whose functions are limited to performing patent registrations, and under these circumstances, Draft 2013 concludes Company S should not share in the intangible returns. This implies, without saying so, that the parent company is the economic owner and, for this reason, should earn the intangible returns.

Case Law

In *Prévost Car Inc. v the Queen*, the Canadian authorities reassessed the taxpayer as the beneficial owner, which the foreign authority would not agree to, ending the competent authority process at an impasse or deadlock. Ultimately, the tax court resolved this issue and double taxation, rejecting the tax authority's arguments for beneficial ownership, and allowing the appeal in favor of the taxpayer.

Velcro Canada Inc. v the Queen is another case where the Tax Court of Canada rejected beneficial ownership, deciding in favour of the taxpayer based on the evidence at trial. *Alberta Power (2000) Ltd. v. Canada* is another case with a significant discussion of beneficial ownership. There are more tax court cases in addition to *Prévost*, *Velcro* and *Alberta Power* that dispute beneficial ownership, which hopefully cause the OECD to reconsider and revise its guidance on the economic ownership of intangibles.

Since the tax authority failed in its arguments for beneficial ownership in these cases, and since the facts and circumstances appear similar to Examples 1, 2, 3 and elsewhere in the 2013 Draft, there is a risk that the paragraph 73 and certain Examples might fail in the tax court for the same or similar reasons.

Finally, the Federal Court of Appeal upheld the tax court decision in the *Prévost* case, specifically affirming:

> … one does not pierce the corporate veil unless the corporation is a conduit for another person and has absolutely no discretion as to the use or application of funds put through it as conduit, or has agreed to act on someone else's behalf pursuant to that person's instructions without any right to do other than what that person instructs it, for example, a stockbroker who is the registered owner of the share it holds for clients.

Recommendation

The above suggests changes are needed in the 2013 Draft, and the Final Version should not dispute the legal ownership and entitlement to intangible profits unless the taxpayer is a conduit for a related party and has absolutely no discretion as to the use or application of the intangibles, or has agreed to act pursuant to the related party's instructions without any right to do other than what the related party instructs it to do.

Compensating Related Party Service Providers

Paragraph 7.31 of the OECD Guidelines states the most appropriate method for pricing related party services is a comparable uncontrolled price (CUP) or a cost plus method in the absence of a CUP.

However, the 2012 and 2013 Drafts introduce a new requirement for pricing related party services that will compensate related party service providers with the **"anticipated value of their contributions"** through their functions, assets and risks as described in paragraphs 65, 73, 74, 77, 86, 90, 92, 93, 95, 97, 255 (Example 8), 265 (Example 11), and elsewhere in the 2013 Draft where phrases like this are used.

This suggests an arm's length price would be (i) a fee for services PLUS (ii) a share of the intangible profits.

This should be accepted if, and only if, the services are priced on the same basis as a third party transaction (CUP) that explicitly states and includes the "anticipated value of their contributions" as part of the service fee, or in addition to the service fee, and is comparable based on the facts and circumstances.

In the absence of a CUP, if a tax authority proposes an adjustment to compensate a taxpayer for the "anticipated value of their contributions", it will likely be disputed as more than an arm's length amount.

This is a continuation of the concerns for legal vs. economic ownership, since "the anticipated value of their contributions" would compensate the related party service provider as the "economic or beneficial owner" of their contributions to the intangibles legally owned by another party. The *Prévost* case and others like it show that the competent authorities will be challenged, possibly unable, to resolve disputes of this nature.

Further, there is a risk tax authorities might propose an adjustment using a HIGHER mark-up to compensate the related party for the "anticipated value of their contributions" to intangibles legally owned by another party.

For example, on 14 August 2013 India issued draft safe harbor rules for public comment which proposes that a taxpayer – e.g., related party service provider operating in India – should earn, for example:

Software development services	operating expenses plus a 20% mark-up
Information technology enabled services	operating expenses plus a 20% or 30% mark-up
Contract R&D for software development	operating expenses plus a 30% mark-up
Contract R&D for generic pharmaceuticals	operating expenses plus a 29% mark-up
Manufacturing and export of auto parts	operating expenses plus an 8.5% or 12% mark-up

If a safe harbor indicates what the Tax Authority is willing to accept as the price for related party services, there is a risk the Indian Tax Administration will reassess taxpayers if the price for services is less than the safe harbor price.

For example, if a taxpayer provides contract R&D for generic pharmaceuticals at cost plus a 10% mark-up, and the 10% mark-up is shown to be within an arm's length range, than it appears the additional 19% mark-up compensates the related party service provider for the value of their contribution to intangibles and possibly other items such as location savings, other local market features, assembled workforce, or MNE group synergies.

Use of comparables drawn from data bases

Although paragraph 148 recognizes commercial data bases as a source of potential CUPs for intangibles, paragraph 149 refers to the difficulty of finding CUPs for intangibles “in many, if not most, cases”, and paragraph 156 says “it will often be the case” comparability analysis reveals there are no reliable CUPs.

The 2013 Draft refers to an old notion, which was once true, that searching commercial databases was frustrating and time consuming exercise with poor results. However, in more recent years, commercial databases have improved significantly in terms of the quantity and quality of third party agreements.

However, contrary to paragraphs 149 and 156 of the 2013 Draft, tax authorities are now using commercial databases to search for third party transactions. This might explain why Mr. Joseph Andrus, head of the transfer pricing unit at the OECD, asked this question during the last public consultation on intangibles:

> “If a tax authority conducts a special project to search for third party terms and conditions in, for example, the biotech industry, is it okay for the tax authority to use this information during the audit of a biotech company?”

In response to this question, Matthew Wall and David Jarcyzk wrote the attached article *Tax authorities using CUPs for pricing transactions*, published by TP Week in March 2013. Please read this article, as it responds to Mr. Andrus’ question, showing there are 2,828 third party agreements in the biotech industry, with further details to dispel the old notions and establish new opportunities for using CUPs reliably.

Please reconsider and revise paragraphs 149, 156, etc. in the Final Version of Chapter VI on Intangibles. Respectfully, it is now “likely” or “more than likely” commercial databases have third party agreements for intangibles that will “potentially” be reliable CUPs depending on the facts, circumstances and analysis.

In the absence of a CUP, tax authorities might use the profit split method to propose an adjustment that recognizes the taxpayer as the “economic owner” of certain intangibles, with the adjustment compensating them for the “anticipated value of their contributions” to intangibles legally owned by another party.

Transactions that are economically equivalent to sales

As part of the supplemental guidance regarding transfers of intangibles or rights in intangibles, paragraph 133 refers to “sales of intangibles as well as transactions that are economically equivalent to sales.”

The notion of “economically equivalent” is explained in *Veritas Software Corporation v Commissioner* by the expert for the IRS who “concluded that the requisite buy-in payment was $1.675 billion and that a 22.2 percent perpetual annual royalty was economically equivalent to the requisite $1.675 billion payment.”[2]

However, using a 22.2% annual royalty for a perpetual period of time suggests that, at some point, the amount being paid for the intangibles, which never ends, will be significantly greater than $1.675 billion. Further, the judgment in the *Veritas* case notes the preexisting intangibles had a useful life of four years, which suggests a 22.2% annual royalty for four years will be significantly less than $1.675 billion.

Please revise paragraph 133 to avoid the risk of a material error and dispute in the valuation of intangibles, preferably by removing the concept of “transactions that are economically equivalent to sales.”

[2] Veritas Software Corporation v Commissioner, U.S. Tax Court, Docket No. 12075-06, 10 December 2009, page 28.

The impact of Goodwill on the price of related party transactions

Paragraph 165 and Examples 18 and 21 of the 2013 Draft identify situations where a multinational company acquired the equity interest of an independent business and raises the issue as to how the goodwill (identified in the purchase price allocation) is factored into the price of related party transactions.

In Example 18, if some portion of the value described in the purchase price allocation as goodwill is retained by the acquired company (now a subsidiary of the multinational company), the 2013 Draft explains the acquired company should be entitled to compensation for such value, either as part of the:

a) Price paid by the related party for the transferred rights to technology intangibles, or

b) Price paid in years following the transaction for the R&D services of its workforce.

First, the answer depends on the nature of the goodwill based on the facts and circumstances. The general principles for business valuations recognize that commercial goodwill is transferrable, but personal goodwill is not transferrable. This has been dealt with extensively and upheld in the Tax Court of Canada. The *Canadian Winesecrets Inc. v the Queen* explains commercial and personal goodwill as follows:

> [16] The respondent's expert clearly makes the distinction between commercial goodwill and personal goodwill. The expert defines those terms as follows:
>
> Commercial goodwill concerns clients' favourable attitudes toward a business. Its value often reflects the benefits it provides certain prospective purchasers in allowing them to enter business quickly and economically by acquiring the existing practice's reputation, established client base, in-place and operational organization, trained and experienced staff, locational advantages, office facilities, and other advantages of an established practice. It is generally recognized that commercial goodwill follows the business, can be transferred to different owners, and therefore, can have material value.
>
> Personal goodwill relates to the ability, skills, experience, contacts, and reputation of individuals. It resides with the individual, is not transferrable per se, and has little or no commercial value.

It would help to add the above explanation for commercial and personal goodwill to the guidance on *Goodwill and ongoing concern value* in paragraphs 60 to 62 of the 2013 Draft, and to apply the distinction between commercial and personal goodwill in paragraph 165 and Examples 18 and 21 of the 2013 Draft.

Example 18 should be revised to clarify the facts and the suggested outcome to consider goodwill in part (a) if it is commercial goodwill, or consider goodwill in part (b) if it is personal goodwill.

Example 21 should be revised, as the example suggests, if the "complementary nature of Osnovni group products with the acquired products" is intended to be commercial goodwill, not personal goodwill.

Second, the 2013 Draft guidance and examples should emphasize that the acquired company is to be compensated ONCE either as part (a) <u>or</u> (b) described above, but NOT TWICE as (a) <u>and</u> (b). This is a common mistake, perhaps because business valuators usually deal with part (a), while transfer pricing specialists deal with part (b), without the two deciding which one (not both) applies in the circumstances.

Finally, the Tax Court of Canada has a lot of case law that specifically deals with goodwill, which deserves consideration, as it provides meaningful guidance on goodwill for transactions between related parties.

Use of valuation techniques

It would be misleading for paragraphs 171 to 198 of the 2013 Draft to suggest, as it does now, that the discounted cash flow is the one valuation method for intangibles, which omits other valuation approaches and methods that might be more appropriate and reliable depending on the facts and circumstances.

The International Valuation Standards Council[3] ("IVSC") states all three valuation approaches (market, income and cost) and their methods can be used for valuing intangibles[4], something that is missing from the 2013 Draft, but should be acknowledged by the OECD in the Final Version of Chapter VI on Intangibles.

> **Market approach** used to value an intangible asset by reference to market activity (e.g., transaction bids or offers involving identical or similar assets).
>
> **Income approach** uses various methods to value intangibles based on the present value of income, cash flows or cost savings (e.g., relief from royalty method, premium profits method, excess earnings method).
>
> **Cost approach** is mainly used for internally generated intangible assets (e.g., self-developed software, websites, and the benefit of an assembled workforce) that have no identifiable income streams.
>
> **Multiple approaches.** Because of the nature of many intangible assets there is often a greater need to consider the use of multiple methods and approaches to derive value than for other asset classes.
>
> **Reference material.** The IVSC provides an overview on *Intangible Assets* in the International Valuation Standards No. 210, detailed guidance on *The Valuation of Intangible Assets* in Technical Information Paper 3, and detailed guidance on the *Discounted Cash Flow* in Technical Information Paper 1.

It is important to recognize all three valuation approaches and their methods. Not doing so would be like Chapter II of the OECD Guidelines focusing only on the transactional net margin method ("TNMM") because it happens to be the most frequently used transfer pricing method. It is important to recognize there will always be facts and circumstances that require the other transfer pricing methods, just as there will always be facts and circumstances that require the other valuation approaches and methods.

Rather than using valuation techniques as "one of the five OECD approved transfer pricing methods", it would be better to revise paragraph 171 to accept the three valuation approaches and their methods as an "other method" in accordance with paragraph 2.9 of the OECD Transfer Pricing Guidelines.

Chapter VI should provide an introduction or overview to explain the three valuation approaches described above and their methods, including the likely facts and circumstances for using each, to ensure transfer pricing specialists, presumably working with an experienced business valuator, use valuation techniques for the right reasons, and select the most appropriate and reliable method given the facts and circumstances.

Please consider moving the detailed guidance and examples for using valuation techniques into an Annex to Chapter VI or as a new chapter in the OECD Guidelines, which would allow for and include specific guidance on all of the approaches (market, income and cost) and their methods for valuing intangibles.

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[3] The International Valuation Standards Council has 74 members in 54 countries including, for example, the Canadian Institute of Chartered Business Valuators ("CBV") and the American Society of Appraisers ("ASA").

[4] International Valuation Standards 2011, "Asset Standards – IVS 210 Intangible Assets", paragraph C16.

Transfer pricing professionals using valuation techniques

Paragraph 176 correctly states a significant concern when valuing intangibles using the income approach and discounted cash flow ("DCF") method which "can be volatile" and goes on to say "Small changes in one or another of the assumptions … can lead to large differences in the intangible value …"

Paragraph 177 correctly states "The reliability of the intangible value … is particularly sensitive to … underlying assumptions and estimates … and on the due diligence and judgment exercised …"

Documentation is not enough. Although paragraph 178 says to "explicitly set out each of the relevant assumptions" and "describe the basis for selecting valuation parameters", this alone will not mitigate the risk of a significant error in selecting and applying the most appropriate method for valuing intangibles.

Experience counts. There is significant risk for transfer pricing professionals that lack the requisite education, work experience and qualifications as a business valuator, as demonstrated by the two transfer pricing professionals hired by the IRS in *Veritas Software Corporation v Commissioner*.

The *Veritas* case focused on the 2000 buy-in payment by Veritas Ireland to Veritas US for the transfer of preexisting intangibles valued at $166 million using a comparable uncontrolled transaction ("CUT").

The expert hired by the IRS for the reassessment is a Ph.D. in economics who specializes in transfer pricing, and he used the income approach to value the intangibles at $2.5 billion. The second expert hired by the IRS for the trial is a Ph.D. in economics who specializes in transfer pricing, and he used the income approach to value the intangibles at $1.675 billion. In the end, the judge rejected both, and accepted the taxpayer's CUT as the most appropriate and reliable method, priced at $166 million with some adjustment.

Respectfully, the judge was highly critical of the valuations performed by the transfer pricing professionals. For example, the judgment in the *Veritas* case (Docket No. 12075-06, 2009) said the experts for the IRS:

> … inflated the determination by valuing short-lived intangibles as if they have a perpetual useful life …
>
> … used the wrong useful life for the products and the wrong discount rate and admittedly did not know …
>
> … Put bluntly, his testimony was unsupported, unreliable, and thoroughly unconvincing.

The *Veritas* case is a good example of the risk for transfer pricing professionals who practice business valuations. The transfer pricing professionals hired by the IRS likely followed guidance for using valuation techniques similar to the 2013 Draft, which led them to valuations of $2.5 billion and $1.675 billion. They were materially wrong based on the underlying assumptions and estimates used, which lacked sufficient due diligence and judgment, errors that a qualified business valuator would be less likely to make.

The Final Version for Chapter VI on Intangibles should include additional cautionary language and guidance that encourages transfer pricing professionals to consider the valuation courses and designation offered by the International Valuation Standards Council and its 74 professional bodies before engaging in the business valuations part of a larger assignment that involves tax, transfer pricing and other issues. Alternatively, transfer pricing professionals should involve and work with business valuators that have the appropriate education, experience and qualifications. This will lead to better answers and fewer disputes.

BEPS focus group on hard to value intangibles

The comments above on using valuation techniques for valuing intangibles are preliminary in nature. Respectfully, I wish to provide more detailed comments during the upcoming BEPS focus group on hard to value intangibles. I am available and interested in assisting the BEPS focus group on this subject.

Tax authorities using CUPs for pricing transactions

12 Mar 2013

Matthew Wall and David Jarczyk explain the new trend where tax authorities use third party agreements to test, and adjust if needed, the arm's length price of related party transactions.

Joseph Andrus, head of the transfer pricing unit at the OECD, asked this question last autumn during the OECD public consultation on intangibles:

ñIf a tax authority conducts a special project to search for third party terms and conditions in, for example, the biotech industry, is it okay for the tax authority to use this information during the audit of a biotech company?ò

We recognise this is a new trend, not an academic discussion.

Background

Many companies use the transactional net margin method (TNMM) or comparable profits method (CPM) for their transfer pricing documentation. This shows the tested party earned an armôs length profit on the sum of related party transactions, which suggests but does not prove individual transactions are priced on an armôs length basis. While the TNMM / CPM is an accepted method in most countries, it might not be enough to satisfy the tax authority in all circumstances.

Many tax authorities now use a risk based approach, focusing on some, but not all, of the related party transactions. This might explain why a tax authority searches for third party data for pricing selected transactions. If the tax authority finds third party transactions, which they consider to be reliable as a comparable uncontrolled price (CUP), the taxpayer should not be surprised when the tax authority uses this information as support for a proposed transfer pricing adjustment for the years in dispute.

The tax authorities are being strategic in using a CUP, which is preferred to another transfer pricing method when both can be applied in an equally reliable manner, for the reasons explained in paragraph 2.2 and 2.3 of the OECD transfer pricing guidelines (2010). The tax courts agree, consistently relying on CUPs in their decisions to the detriment of the TNMM / CPM and other methods. More on this later.

Tax authorities searching for CUPs

Tax authorities have been quick to learn databases for third party agreements have come a long way. For example, ktMINE has more than 50,000 royalty rates and 80,000 license agreements, 15 million US patents and patent assignments, 10 million US trademarks and trademark assignments. Further, the interface was designed with the transfer pricing professional in mind, allowing them to search using specific criteria, view results in a summary format, refine the search using other criteria, document all of the search steps taken, export data, and view selected agreements to assess their comparability.

Jarczyk has been training tax authorities in Canada, the US, UK, Australia and other countries on how to search ktMINE for third party transactions to price related party transactions. This may be news for taxpayers, and suggests they might need to do their own search at some stage of an audit.

Wall says using these databases have increased the probability of finding potential CUPs when, not too long ago, this was often a frustrating and time consuming exercise with poor results.

What will the tax authority find?

Getting back to Andrusô question, this article shows a tax authority would find 2,828 agreements for the biotech industry if they searched the ktMINE database. Below are further details that dispel old notions.

We sorted the agreements by territory for each of the five continents, finding 38 in Africa, 204 in Asia, 141 in Europe, 485 in North America, 57 in South America, 61 in Oceania, 1,292 worldwide and 550 in countries not yet assigned to one of these territories. This shows the database covers more than just the US and there are agreements in substantial numbers across all five continents for the biotech industry.

We also sorted the biotech agreements by type and found 123 for asset purchase, 31 for cross license, 249 for distribution, 493 for joint development, 2,474 for manufacturing/process intangibles, and 685 marketing intangibles. Note there are 1,227 agreements that overlap other types of transactions. This shows there are agreements for the types of transactions that are often audited by the tax authority.

We also checked the aging of these agreements and confirm that the number of agreements in three year intervals were 176 from 2012 to 2010, 276 from 2009 to 2007, 444 from 2006 to 2004. This shows agreements are being replaced in significant numbers on a rolling basis.

These are just a few of the criteria used to narrow the search. At some point, you will review the results summary to assess (accept / reject) which of the agreements might be comparable to the related party transaction. There is a summary for each agreement that includes a short synopsis, name of the parties, effective date, term, type of agreement, industry, SIC code, territory, exclusivity.

Click a button for a copy of the actual agreement including its terms and conditions.

Jarczyk says this shows ktMINE and other databases like it will help the tax authorities find relevant agreements in the biotech industry and, knowing they are already using them, suggests taxpayers and their advisers should also consider this information, particularly if it helps resolve their differences.

Must be comparable

Wall recognises these databases are now useful in ways they once were not, but cautions successfully using these databases will depend on an effective search strategy in order to find relevant third party transactions, plus additional analysis to show the transaction is comparable in accordance with the OECD guidelines, before it will be considered reliable for pricing related party transactions.

In brief, the comparability, as explained by the OECD guidelines, requires the ñeconomically relevant characteristics of the situations being compared must be sufficiently comparableò which refers to the five comparability factors of: Characteristics of property or services; functional analysis, assets used and risks assumed; contractual terms; economic circumstances; and, business strategies.

Differences between transactions do not exclude a third party transaction from being a CUP for pricing the related party transaction provided, according to paragraph 2.14 the OECD guidelines:

a) None of the differences (if any) between the transactions being compared or between the enterprises undertaking those transactions could materially affect the price in the open market; or

b) Reasonably accurate adjustments can be made to eliminate the material effects of such differences.

If a third party transaction is found to be relevant, but not entirely reliable (that is comparable), the information might still be used as support for other transfer pricing methods and analysis.

Is it okay for the tax authority to do this?

To answer Andrusô question, the issue should no longer be is it okay to use these databases, since it is welcome news to find credible sources of third party agreements that might be used as CUPs. The issue becomes when is it okay to use these databases, and how should they be used.

Wall responded to ñwhen is it okayò last autumn during the OECD public consultation on intangibles. He stressed the tax authority has an obligation to first consider the legal form of the agreement between related parties and economic substance of the transaction including the transfer pricing documentation provided by the taxpayer. Paragraph 1.64 of the OECD guidelines suggests a tax authority can use this information only in ñexceptional casesò because in doing so the ñ... tax authority disregard the actual transactions or substitute other transactions for themò which risks ñrestructuring of legitimate business transactions would be a wholly arbitrary exercise the inequity of which would be compounded by double taxation created where the other tax administration does not share the same viewsò.

Respectfully, it would be inappropriate for a tax authority to begin an audit with the intent of using this information, which might prejudice their request for, and interpretation of, the taxpayerôs information. However, in light of this article, it is understood that the tax authority might use this information at a later stage of the audit under specific circumstances, which requires more guidance from the OECD.

Jarczyk explains the second part of ñhow should they be usedò, saying anyone can find good benchmark agreements given the size of this database. However, experience counts, the more the better, which helps in the search strategy and comparability analysis to show relevant transactions are reliable as CUPs for pricing related party transactions. This explains why tax authorities ask for training on how to use ktMINE effectively.

Advice for taxpayers

Wall says, at some stage of the audit, taxpayers might need to request and review the third party transactions that the tax authority found, conduct their own search for third party transactions, or both. Be careful though, while the taxpayer should use this information to supplement their existing documentation for a selected transaction, the tax authority might use this information to dispute the armôs length price including the taxpayerôs documentation for this same transaction.

Jarczyk adds that tax authorities are also using ktMINE to search for third party agreements to answer the question ñwould a third party actually agree to these terms and conditions?ò Wall explains this might lead the tax authority to dispute the characterisation of the taxpayerôs transaction, which is much more serious than disputing the armôs length price of a transaction between related parties.

Finally, third party agreements can also be used for tax planning, transfer pricing documentation, advanced pricing agreements, requests for competent authority, and expert reports for the tax court.

Case law

Wall was the transfer pricing expert in *Alberta Printed Circuits v. Her Majesty the Queen* and says this is a good example where CUPs prevailed over the TNMM in the decision by the Tax Court of Canada. Another example is *SNF (Australia) Pty. Ltd. V. Commissioner of Taxation*. These cases are precedent setting.

Richard Ainsworth and Andrew Shact, from the Boston University School of Law, studied these and other cases before concluding ñCUPS are the judicial gold standardò and ñall transfer pricing regimes give priority to the comparable uncontrolled price (CUP) methodò in their article *Transfer Pricing: The CUP – Case Studies: Australia, US, UK, Norway and Canada.* This is an excellent article, worth reading.

In brief, Ainsworth and Shact discuss the tax courtôs decision in five different cases, each case from a different country, including examples for exact CUPs, adjusted CUPs, and phantom CUPs. They also explain why each CUP succeeded or failed given the facts and circumstances of the case.

Freedom to choose

Taxpayers and their advisers have the freedom to choose the most appropriate and reliable method for pricing related party transactions. However, if the taxpayer chooses the TNMM / CPM to show the tested party earned an armôs length profit, the tax authority might claim this does not prove that one of the transactions selected for audit, from the list of transactions, is at an armôs length price.

The tax authorities are now using third party agreements to test, and adjust if needed, the armôs length price of related party transactions. This is a new trend, not an academic discussion, and one that taxpayers and their advisors must face.

The key concern, perhaps for the next OECD public consultation, is not that the tax authorities use these databases, but when is it okay for tax authorities to use these databases, and how should they be used.

Matthew Wall is the founder of MDW Consulting Inc., an independent firm that specialises in transfer pricing, and member of the Altus Alliance, an international network of transfer pricing professionals. Matthew was the transfer pricing expert in the Alberta Printed Circuits Ltd. case, which the Tax Court of Canada decided based on his expert report and testimony.

David Jarczyk is the founder and President of ktMINE, an intellectual property (IP) information services firm focused on delivering IP protection and competitive advantage to analysts and IP owners across the globe. Before this, David was a transfer pricing economist for many years, assisting multinational companies price their related party transactions.