FRESHFIELDS BRUCKHAUS DERINGER

Memorandum

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Proposed Revision of Chapters I-III of the Transfer Pricing Guidelines: Comments

Dear Mr Owens,

We are pleased to present the comments of Freshfields Bruckhaus Deringer LLP on the proposed revision of chapters I-III of the Transfer Pricing Guidelines (***TPG***) which were released on 9 September. We have deliberately focused on six key issues rather than commenting on every detail.

In general we recognise that the proposed revision is a significant achievement, representing as it does a potential consensus between some very diverse tax authority perspectives. We welcome the more equal status that has been given to transactional profit methods (for example, paragraphs 2.1, subject to the caveats in paragraph 2.2), the acceptance of a wider range of profit level indicators, for example the Berry Ratio (paragraphs 2.8 and 2.139-2.142) and the clarification that quality is more important than quantity when reviewing potential sets of comparables (paragraphs 1.50 and 3.32). However, we have a number of suggestions for addressing some potential ambiguities and misunderstandings of what we believe is intended. We have set these out below broadly in the same order in which they appear in the revision.

1. ***Choice of method*** - While paragraph 2.1 states that "the applicability of any particular method need not be disproved", and "finding the most appropriate method…does not mean that all the transfer pricing methods should be analysed in depth or tested in each case", paragraph 2.7 states that "the selection of a transfer pricing method always aims at finding *the* most appropriate method", paragraph 2.10 refers to the selection of "one method that is apt to provide *the* best estimation of an arm's length price" and paragraph 3.5 (Steps 3 and 6) refers to "selection of *the* most appropriate transfer pricing method" (emphasis added) as does paragraph 3.6. While paragraph 2.7 adds that this "does not mean that all the transfer pricing methods should be analysed in depth" and paragraph 2.10 states that "these Guidelines do not require…the taxpayer to perform analysis under more than one method", the strong implication of the proposed revision is that there is a single "best" method which

can only be confirmed by review of the other methods and an explanation of why they have been rejected. We suggest that the requirement should be to identify *an* appropriate method where "appropriate" is defined as not creating, ex ante, a financial result for either party which would not have been rational at arm's length.

2. ***Role of the profit split method*** – We are concerned that the proposed revision to the TPG appears to give more authority to tax administrations to find fault with the use of methods other than the profit split method, such that they may refer to the profit split more often, or even automatically, as a or the corroborative method, or even as the method to be used in place of that used by the taxpayer. For example, paragraphs 1.36 to 1.62 refer in more detail than before to aspects in which transactions may not be comparable to the one which is being tested, while paragraphs 2.101 to 2.117 and 2.143/2.144 discuss many potential weaknesses of the transactional net margin method (not all of them correct – for example, the statement in paragraph 2.101 that "a transactional net margin method is unlikely to be reliable if both parties to a transaction contribute unique intangibles" should go on to read "which have a significant impact on their profitability" – many if not most companies have unique intangibles to some small degree). paragraph 2.108 goes further and states explicitly that "it might be useful in some circumstances to corroborate the conclusion of a transactional net margin method with a transactional profit split method, in order to avoid having a *disproportionate* amount of an MNE's overall profit…accruing to the tested party" (our emphasis added). This is a value-laden statement which in our view gives far too much ammunition to tax administrations.

3. ***Secret comparables*** - Paragraph 3.35 suggests that it would not be "unfair" for a tax administration to apply a transfer pricing method on the basis of "information available to [the tax administration] from examinations of other taxpayers or from other sources of information that may not be disclosed to the taxpayer [as long as] the tax administration was able…to disclose such data to the taxpayer so that there would be an adequate opportunity for the taxpayer to defend its own position." We suggest that this proposal is fundamentally at odds with what should be the starting point for any transfer pricing audit, namely whether the transfer pricing policy would have appeared to be arm's length to the taxpayer based on information readily available to it at the time the price was set. To introduce subsequently into an audit information which was not available to the taxpayer at the time, or quite possibly to any party at the time, is to introduce information which could not have informed an arm's length negotiation involving the taxpayer at the time. It is to hypothesise a negotiation which, by definition, could not have happened.

4. ***Arm's length range*** – The recognition in paragraph 3.56 that statistical tools such as the interquartile range can "help to enhance the reliability of the analysis" is welcome, although the real issue is that the interquartile range has become a convention in transfer pricing which the TPG are still struggling to keep up with, even after the proposed revision. Thus the implication of paragraph 3.56 as drafted is that the use of a measure of "central tendency" such as the interquartile range should *only* be considered where it is known that comparability defects remain in the benchmark set and have not been adjusted for. Apart

from the difficulty that limitations in information, or in the time and/or budget with which to review it, may mean that in many cases the potential comparability defects cannot be established (paragraphs 5.6, 5.7 and 5.8 indicate that the taxpayer should only be required to make a reasonable application of the requirement to document comparability, as noted under "Administrative Burden" below), we suggest that such a (possible) interpretation of paragraph 3.56 is too limiting. In practice, the full arm's length range is often too wide to be of practical value to taxpayers in setting prices and therefore a measure of central tendency such as the interquartile range is routinely used to narrow down the range. We suggest that this practical reason for referring to a narrower range should be acknowledged in the TPG. On a related point, we note that paragraph 3.55 allows for less comparable "transactions" to be eliminated from the comparables set, whereas paragraph 3.56 refers to "observations", which is a better term as it covers examples of company profitability as well as individual transactions.

We welcome the implied instruction in paragraph 3.59 that tax administrations should not be allowed to limit the arm's length range to a measure of central tendency where the taxpayer can "establish [the] fact" that other observations are also comparable, although we suggest that the burden of proof should fall instead on any tax administration which wishes to refer to a narrower range than the one which was referred to by a taxpayer in setting its transfer prices.

We suggest that paragraph 3.60 should be deleted because it recommends that a tax administration should be allowed to adjust a transfer price to a single point within the arm's length range. While a caveat is included, namely that this single point should be the one which "best reflects the facts and circumstances of the particular controlled transaction", there are two problems with this guidance: first, that it ignores the guiding principle of there being an arm's length "range", rather than "most comparable observations" (paragraph 3.54 notes that "there will…be many occasions when [there will be] a range of figures all of which are relatively equally reliable") and second, that it may be interpreted by some tax administrations as support for an adjustment of all non-arm's length pricing to the median or mean of the comparables set.

We believe that taxpayers who deliberately set non-arm's length transfer prices should be punished through penalties, and not by an *arbitrary* adjustment to their transfer pricing, which could be a source of double taxation or administrative burden in the taxpayer's dealings with another tax administration. We therefore have particular concerns about the explicit reference in paragraph 3.61 to adjustments to the median or mean, as there is no more reason to believe that they are comparable to the controlled transaction than any other point in the arm's length range. (We also suggest that the guidance on which measure of central tendency should be referred to – "depending on the specific characteristics of the data set" – raises rather than answers questions and (if it is not deleted) should be fleshed out to avoid different interpretations.)

We welcome the instructions to tax administrations in paragraph 3.62 that observations cannot be excluded from the arm's length range simply because they are "very different" from other results, and (in paragraphs 3.63 and 3.64) that companies should not be excluded from the comparables set simply because they reported losses. Both types of exclusion occur all too frequently at present.

5. ***Use of hindsight*** - Linked to the discussion of secret comparables above, we suggest that paragraph 3.73 does not go far enough in qualifying its opening statement that "data from years following the year of the transaction may also be relevant to the analysis of transfer prices." While it is true that the subsequent results of supposedly comparable transactions or companies can be a useful guide as to whether they were indeed comparable, and that the subsequent behaviour of the related parties can be a useful guide as to whether a certain method should have been used, the point should be made more clearly that, other than in these specific respects, data from years following the year of the transaction is not to be referred to in a transfer pricing audit, because it relates to the different economic circumstances that developed at a later point in time, and to market information that could not have been available to the taxpayer at the time. The *only* exception should be that which is suggested at paragraph 3.72, namely that when a tax administration has first proven "that the parties at arm's length would have required a price adjustment mechanism", and second that the tax administration can prove that there is reliable information on how that price adjustment clause would have operated, including the level of change in a cost, revenue or profit figure which would have triggered a price adjustment, and then by how much the price would have been adjusted. This onus of the burden of proof on the tax administration, and the series of steps which the tax administration would be required to prove, should be made clearer in paragraph 3.72.

In a similar vein, we suggest that paragraph 3.3, which states that "the fact that *reasonable* efforts have been made in finding and selecting comparables cannot rule out the possibility that more reliable comparables data may *ultimately* be found and used in determining an arm's length outcome" [our emphases added], should be deleted. By definition, if transfer prices are based on a "reasonable" level of market research that any other company acting at arm's length at the time would have carried out, then they must be "arm's length" for practical purposes.

6. ***Administrative burden*** – We welcome the references in paragraph 3.79 to paragraphs 5.6, 5.7 and 5.8 which "contain explicit recognition of the need for a *reasonable* application of the requirement to document comparability" (our emphasis added), the confirmation in paragraph 3.80 that "when undertaking a comparability analysis, there is no requirement for an exhaustive search of all possible relevant sources of information", and the reference to a principle of "prudent business management" in paragraph 3.81.

Nonetheless, we suggest that the wording of paragraph 3.81 still places too great an administrative burden on taxpayers where it states that "for *simple* transactions…a detailed comparability…analysis *might* not need to be done every year, as long as the financial information on comparables is updated *and* its relative comparability is updated *annually*" (our emphases added). It is quite common for taxpayers to refer to a multiple year average benchmark range, which would be less susceptible to annual fluctuations, and also to avoid the significant costs of benchmarking by only carrying out such exercises once every three years or so. Paragraph 3.81 now implies pressure on all companies for all transactions, no matter how small and/or simple, to carry out annual benchmarking. Not only that, but it also requires them to "establish relative comparability" annually. At the very least, some guidance is required (perhaps by cross-referencing to other paragraphs) as to what this means, but we suggest that more work can be involved in establishing the comparability of a transaction or company than in gathering its latest financial information – for example, has the nature of the goods or services in question changed, has the role of the party or parties involved changed, or has the business strategy changed? If the intention of the paragraph is that it is legitimate for a taxpayer with a simple transaction to refer for several years to the updated figures for a fixed set of benchmark transactions or companies, unless there is an obvious reason to now exclude one of them, then this would be welcome and should be made clearer.

We hope you will find these comments helpful.