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§ 1.40 : The Linkage between the applicable transfer pricing methods and comparability factors has been made more explicit. The OECD takes a firm stance against an approach that is used more and more in practice. The reliance on very broad and generic categories of comparables cannot be a default transfer pricing approach. The application of the arm's length principle does entail a solid analysis of facts and circumstances.

§ 1.53 : It is important to recognize that analysing contractual terms is often not possible for potential comparable transactions (or comparable companies). However, the more obvious example that triggers debate in practice – pertaining to the supply of products and the underlying contractual terms and conditions – is not being addressed.

To illustrate, the supply of products under limited risk distribution agreements tends to trigger questions about whether the terms and conditions of comparable independent buy-sell distributors are similar. Practitioners often argue that comparable buy-sell distributors have contractual terms that expose these comparable companies to more risks (e.g. more exposure to inventory obsolescence risks), while it is difficult to prove this because the underlying terms and conditions are not disclosed in the public domain. It would be helpful to provide some guidance that industry practice can provide relevant insights into what typical terms and conditions are expected to be in place between third parties. After all, these considerations are particularly helpful in deciding the most appropriate point within a range.

§ 1.56 to 1.57 : One point is not exactly clear: that is the question of foreign source or non-domestic comparables. As para 1.57 refers to para 3.34 and para 3.34 refers back to paragraphs 1.56-1.57, finally these two points do not give a clear guidence in this issue.
This guidance is helpful because it provides support for reliance upon regional approaches if the facts and circumstances of the multinational enterprise are consistent within defined regions but arguably not sufficient. Whether or not a market can be considered homogeneous is very much dependent on interpretation. To illustrate, the Dutch tax authorities tend to have a different interpretation of how homogeneous the EU market is as compared to the French tax authorities, with the latter being notorious for a strong bias towards French comparables.

§ 2.1 : 'Most appropriate method' (2.1 et. seq) is still rather close to a 'best method' rule and ideally should be replaced by 'an appropriate method'. The introduction of the newly proposed second chapter reconfirms that no one method is suitable in every possible situation, and the applicability of any particular method need not be disproved. More importantly, the introduction addresses the historic distinction and hierarchy between traditional transaction methods and transactional profit methods in a different (and more realistic) manner. In other words, the appropriateness and applicability of any of the OECD-accepted transfer pricing methods is entirely dependent on the facts and circumstances of the case without any preconceived notions. Nonetheless, if the comparable uncontrolled price (CUP) method and another transfer pricing method can be applied in an equally reliable manner, the CUP method is to be preferred. Furthermore, the proposed revisions introduce three particular examples that indicate that transactional profit methods are found to be more appropriate than traditional transaction methods:

1. Where, considering the functional analysis of the controlled transaction under review and an evaluation of the comparable uncontrolled transactions, it is found that a net profit margin analysis is more reliable than a gross margin analysis, e.g. because there are material differences in functions between the tested and the uncontrolled transaction which are reflected only in operating expenses below the gross margin level.
2. Cases where the presence of significant unique intangibles contributed by each of the parties to the controlled transaction or the engagement in highly integrated activities makes a transactional profit split more appropriate than a one-sided method.
3. Where there is no or limited publicly available reliable gross margin information on third parties, traditional transaction methods might be difficult to apply in cases other than those where there are reasonably reliable comparables, and a transactional profit method.

§ 2.7 : Unfortunately, the statements of the original OECD Guidelines which provide that transactional profit methods may not be applied automatically simply because there are difficulties in obtaining data, are still included and remain largely unchanged. More guidance around availability of data and the link with transactional profit methods would have been helpful.

§ 2.63 : Part III of Chap. II provides a detailed discussion of the transactional net margin method and in particular the transactional profit split method. The most notable changes (or clarifications) regarding strengths and weaknesses of the transactional profit split method are mentioned above

§ 2.65 : The changes regarding the underlying considerations with respect to strengths and weaknesses provide for much more recognition that the profit split method is applicable in many cases. Arguably even more interesting is the practical guidance in terms of how to apply the profit split method.

§ 2.71 : There are seven conditions mentioned regarding the profit split (in relation to the profit that will be split and the actual splitting factors):

1. It should be consistent with the functional analysis of the controlled transaction under review, and in particular reflect the allocation of risks among the parties.
2. It should be consistent with the determination of the combined profit to be split and of the splitting factors which would have been agreed between independent parties.
3. It should be consistent with the type of profit split approach (e.g. contribution analysis, residual analysis, or other; ex ante or ex post approach).
4. It should be capable of being measured in a reasonably reliable manner.
5. If a transactional profit split method is used to set transfer pricing in controlled

transactions (ex ante approach), it would be reasonable to expect the criteria or allocation keys to be agreed in advance of the transaction.

6. The person using a transactional profit split method (taxpayer or tax administration) should be prepared to explain the appropriateness of the method as well as the way it is implemented, and in particular the criteria or allocation keys used to split the combined profit.
7. The determination of the combined profit to be split and of the splitting factors should generally be used consistently over the life-time of the arrangement, including during loss years, unless independent parties at arm's length would have agreed otherwise and the rationale for using differing criteria or allocation keys is documented, or if specific circumstances would have justified a re-negotiation between independent parties.

In terms of the primary approaches for splitting profits, the focus remains on the contribution analysis on the one hand and the residual analysis on the other. While the original guidance pertaining to the contribution analysis was very much focused on market data, it is now explicitly stated that in the absence of market (comparables) data, the contribution analysis is based on the relative value of the functions performed by each of the associated enterprises.

Furthermore, there is much more recognition for the use of specific splitting criteria or allocation keys for which two primary conditions should apply, namely that the splitting criteria or allocation keys must be:

– reasonably independent of transfer pricing policy formulation, i.e. they should be based on objective data (e.g. sales to unrelated parties), not on data relating to the remuneration of controlled transactions (e.g. sales to related parties); and
– supported by reasonably reliable comparables data, internal data or both.

Based on these conditions, it appears that the OECD favours relatively simple applications of the profit split that rely on transparent, objective data. It is not entirely clear whether the sophisticated approaches that have been developed in practice to quantify the contributions from parties through functional analysis information by weighing and measuring functional contributions, is receiving less support under these proposed revisions.

Especially companies with highly integrated business processes may have much more refined and sophisticated approaches to determine the value and relative contribution of entities to the companies' business processes.

The actual allocation key can be a (fixed) figure to define (fixed) percentage splits, or a variable which could be derived from the relative value of a contribution as measured by relative investments or costs. Although it is stated that it would not be desirable to establish a prescriptive list of allocation keys, several examples from practice are provided. It is recognized that cost- and asset-based allocation keys are the most common, while other allocation keys such as incremental revenue, time spent or other metrics have been observed as well. Such keys can be used (only) where there is a strong correlation between the actual key and the creation of value in the context of the controlled transaction. Cost-based allocation keys are considered especially relevant in the context of activities where people functions are the primary factor in generating the combined profit. It must be noted that both cost-based allocation keys and asset-based allocation keys may entail accounting challenges (e.g. regarding valuations or classifications).

Regarding reliance upon either external or internal data, it is recognized that profit split arrangements between third parties are not uncommon.

Three examples are provided in this context:

1. Joint-venture arrangements between unrelated parties under which profits are shared, such as development projects in the oil and gas industry; pharmaceutical collaborations, co-marketing or co-promotion agreements; arrangements between independent music record labels and music artists; uncontrolled arrangements in the financial services sector; etc.
2. Franchise agreements showing how a franchisor and franchisee may expect to share the profit of the franchise.
3. Uncontrolled licence or other agreements that have pricing between the parties that is dependent upon profits, such as licence agreements that call for an explicit sharing of profits, licence agreements that have royalty rates that vary depending upon profits, or third-party transactions with contingent payment terms generally.

§ 2.98 : However, when there are no sufficiently reliable external data, it is clearly stated that consideration should be given to internal data. Furthermore, the following language is added regarding internal data

§ 2.108 : In other words, routine functions can in principle always be priced based on a one-sided analysis. There are no real substantive changes regarding the actual application of the transactional net margin method. There is more guidance around the difference between a gross profit and a net profit analysis, but this ultimately does not entail a different application of the transactional net margin method.

§ 2.117 to 2.118 : The discussion on TNMM is very helpful, however in our view still falls slightly short of what is possible in practice. The wording should be softened here - for example in 2.100 the statement that a functional analysis of the controlled and uncontrolled transactions **is required** [emphasis added] should be qualified by adjectives such as 'ideally' or 'where possible'.
Leaving 2.116 with effectively the same wording as old para 3.39, as well as the long 'wish list' in the comparability standard for TNMM (2.110-2.117), tends to undermine the otherwise admirable effort in these revisions to recognise that often TNMM is the only practical way forward.
If the result is to make TNMM so difficult that profit split becomes the 'default' mechanism it will result in extra work for taxpayers and tax authorities alike and, in our view, bring in too much subjectivity. The advantage of a database search for profits of comparable companies that it is more objective and less reliant on judgement factors than some other methods, albeit that it is a blunt instrument at times.

§ 2.131 : The latter point indicates that “entity-wide” testing in cases where controlled and uncontrolled transactions are mixed, is not consistent with the transactional net margin method approach. Furthermore, it is specified that cost-based indicators should be used only in those cases where costs are a relevant indicator of the functions performed, assets used and risks assumed by the tested party. There is also specific guidance regarding the potential treatment of costs as “pass-through” costs to which no profit element is attributed. To the extent that a detailed analysis of the facts and circumstances would justify this approach, the underlying comparability analysis can prove to be a hurdle if this distinction cannot be made regarding the comparable companies.

There is a noteworthy section regarding the use of actual costs versus standard costs. It is recognized that between third parties, it is more common to work with standard or budgeted costs instead of actual costs. Although the proposed revisions appear to embrace using standard costs instead of actual costs, from a practical perspective these approaches may be more difficult to defend. If there are (significant) deviations between standard/budgeted costs and actual costs, taxpayers may have to demonstrate that the original standard costs were realistic – which can often be a challenge (and burdensome).

A return on assets (or capital) is deemed an appropriate base in cases where assets (rather than costs or sales) are a better indicator of the value added by the tested party, e.g. in certain asset-intensive manufacturing activities. The guidance for using such an approach does recognize the valuation and classification challenges. In practice, such challenges may entail that a cost-based approach is considered more reliable.

§ 2.141 : The ratio is considered appropriate in so-called intermediary roles. The example that is provided involves purchases from related parties and subsequent on-selling to other related parties. Finally, there are some interesting statements regarding the use of non-transactional third-party data when relying upon external comparables. In view of the fact that in many cases, the only data available for third parties are company-wide data, the functions performed by the third party in its total operations must be closely aligned to those functions performed by the tested party with respect to its related-party dealings. Again, this statement can be viewed as a stance against applying very broad comparability criteria to simply rely upon relatively generic comparables sets.

§ 3.1 : The new chapter regarding the comparability analysis is the chapter that clearly takes a different direction as compared to where part of the practice has moved to. For a number of years, there has been an increasing reliance upon standardized searches with rather generic samples.

These generic samples are often characterized by very broad screening criteria (e.g. merely relying upon four-digit industry classifications) and/or using databases with smaller comparables bases. Furthermore, the increased popularity of software that combines documentation and comparables search capabilities has contributed to the more generic approaches to comparables searches. This chapter takes us all back to the starting point: a thorough analysis of facts and circumstances.

The new section makes a number of clear statements.

Furthermore, the OECD also states that in principle, the comparability analysis aims at finding the most reliable comparables. This does not entail a requirement for an exhaustive search of all possible sources of comparables in view of information limitations and the potentially burdensome nature of a comparables search. Nonetheless, 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. This effectively means that taxpayers are at risk if the comparables search process is not sufficiently thorough.

§ 3.5 : Although most of these steps are relatively straightforward, but require thorough factual analyses, it is stated that the broad-based analysis is an essential step in the comparability analysis. This can be defined as an analysis of the industry, competition, economic and regulatory factors and other elements that affect the taxpayer and its environment (but not yet within the context of looking at the specific transactions in question). In reviewing the controlled transaction and choice of the tested party, the proposed revisions continue to state that the arm’s length principle should be applied on a transaction-by-transaction basis.

However, a portfolio approach is introduced, under which certain transactions can be bundled if the portfolio approach is part of the company’s business strategy. Furthermore, the term "tested party" is also introduced, which should be the party with the less complex functional analysis.

The step regarding internal comparables is considered a very significant one, arguably also in view of the fact that internal comparables are in practice often “overlooked”. Internal comparables may have a more direct and closer relationship to the transaction under review, but are not always necessarily more reliable. Furthermore, the guidance regarding external comparables and sources of information contains considerable details regarding databases. It is stated that the use of commercial databases should not encourage quantity over quality.

Furthermore, the database search may need to be refined with other publicly available information. This refinement of the database search with other sources of information is meant to promote quality of standardized searches. The use of foreign-source or non-domestic comparables and the relative reliability should be assessed through an analysis of the five comparability factors, instead of default rejections of non-domestic comparables.

There is also detailed guidance regarding the selection and rejection criteria. Both qualitative and quantitative (i.e. financial screening) are considered appropriate, and it depends on the facts and circumstances of each particular case what is applicable.

Step 8 in the process entails comparability adjustments, and there is now more specific guidance regarding such adjustments. However, and rather unfortunately, the OECD took the safe route by providing only substantive guidance regarding working capital adjustments. The “real” challenge in practice pertains to risk differences and this is not really addressed.

The guidance regarding the use of an arm’s length range (and the appropriate point within such a range) does not introduce real changes, but does acknowledge the use of an interquartile range and also provides considerations for the treatment of extreme results (e.g. elimination of loss-making comparable if the losses do not reflect normal business conditions).

§ 3.30 : Commercial databases have different level of reliability and there may be a risk that some databases may be considered as more correct than others by tax authorities in one jurisdiction. Especially it will be important for transfer pricing policies or transfer pricing documentation prepared for the purposes of international group using pan-European data.

§ 3.34 : One point is not exactly clear: that is the question of foreign source or non-domestic comparables. As para 1.57 refers to para 3.34 and para 3.34 refers back to paragraphs 1.56-1.57, finally these two points do not give a clear guidence in this issue.

§ 3.37 : Sometimes different geographical markets and different industries are less comparable than truly comparables companies (same industry, market, functions and risk) that are NOT independent. In some vertical integrated industries is very complicated to find independent companies and a different industry that has similar functions will not be enough to test the transactions, that is why comparables companies that are not fully independent but in the same industry and market could be more reliable. In these cases, it would be important to have as more observations/companies as possible and include companies that have the less controlled transactions. Pragmatic solution may need to be found, on a case-by-case basis.

§ 3.69 : The section on ex post adjustments (para 3.69) is left very open, implying that retroactive adjustments to the results of taxpayer entities are equally acceptable as ex ante price setting, and relies on Competent Authorities to resolve the inevitable differences. We suggest this section is amended in line with para 4.39 of the original guidelines (which makes clear that most OECD countries believe transfer pricing should be set in advance, and do not require one-sided corresponding adjustments after the event).

§ 3.80 to 3.82 : We see many taxpayers struggling to prepare and maintain documentation in the area of comparability. The more systematic approach adopted in the new draft chapters is helpful but could perhaps be cherry picked/taken out of context by a tax inspector looking to find reasons to reject the taxpayer's comparables analysis. In the real world perfect comparables are elusive and it is important to recognise that where taxpayers have made an effort they should not be exposed to penalties. The references to 'reasonably reliable comparables' (eg 3.37, 3.80) help somewhat, but the wording around this remains rather vague. We would very much welcome the insertion of a 'wrap-up' clause to confirm that it is recognised that imperfect comparables (and imperfect information on those comparables) will exist, and provided the taxpayer has made a pragmatic risk-based approach to its efforts to search for comparables, it should not be penalised by tax authorities.
Solid risk management recommendation, MNE should establish risk control frameworks as part of the corporate transfer pricing function.
The proposed revision of Chaps. I through III of the OECD Guidelines introduces a number of significant clarifications. First, the sections regarding the hierarchy of transfer pricing methods and the guidance regarding the application of transactional profit methods, bring a much needed “sense of reality” to the theoretical framework. Arguably, in these particular areas there should be less room for interpretation differences regarding the regulatory aspects. It may introduce a greater potential for interpretation differences regarding facts and circumstances, but this is probably unavoidable. Time will tell whether tax authorities will increasingly determine that the transactional profit split is the most appropriate methodology given the facts and circumstances. In view of the level of detail devoted to this methodology, it is not unreasonable to expect a significant increase in usage of this methodology.
The revisions regarding the comparability analysis can almost be considered a reality check for practitioners. All the guidance surrounding the comparability analysis really emphasizes the importance of aligning the facts and circumstances with a thorough analysis of the five comparability factors. Standardized and generic approaches to comparables searches are rejected and not considered to be consistent with the arm’s length principle. This area of guidance will arguably trigger the most changes for the business community. Many companies may need to reconsider and/or revise their approaches for complying with the arm’s length standard.
Certain other areas that could use new guidance have not been sufficiently addressed. The discussion regarding non-domestic comparables is certainly not finished with the current revisions. Stronger statements or more specific guidance to describe under which circumstances

domestic comparables may be deemed more appropriate would have provided the desired clarity. The general comments about homogeneous markets will not be sufficient to eliminate the uncertainties in this area. Also, the guidance regarding comparability adjustments avoided the potentially sensitive issue surrounding adjustments for risk differences. Working capital adjustments generally do not reflect so much controversy while adjustments for risk differences are much more disputed.

Regarding methodologies, in particular the transactional profit split method, there is a clear tendency towards using objective and relatively simple financial criteria. There is little recognition for more economic approaches and/or discussions regarding “simulating third party behaviour” (in the absence of comparables) based on economic models. The lack of coverage is perhaps unintended, but more recognition of alternative approaches that are based on economic models would have been welcomed.

In general, the proposed revisions are an important step in reinforcing the arm’s length principle and providing the necessary guidance in a changed environment. If the revision is ultimately adopted, it will certainly provide more pressure on the corporate transfer pricing function, as it will be deemed too risky to continue to rely upon standardized and generic approaches.