Practical issues relating to the choice of comparables in transfer pricing

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What is comparability?

- Corner stone of transfer pricing analyses

- International consensus around the arm's length principle: allocate taxable profits to subsidiaries of multinational enterprises as if they were acting independently

- Rejection of global formulary apportionment

What is comparability?

- Governments need a fair allocation of tax bases
- Taxpayers need to avoid double taxation
- Can only be achieved through development and enforcement of an international standard

What is comparability?

- Comparisons of conditions of taxpayer's relations with those of independents

- Determination of quantum of adjustment (comparison of taxpayer's profits with profits which would have accrued at arm's length)

What is comparability?

Article 9-1 of the OECD and UN Model Tax Conventions:

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

Existing guidance on comparability

Chapter I of the 1995 OECD Transfer Pricing Guidelines ("the TPG"):

"To be comparable means that none of the differences (if any) between the situations being compared could materially affect the condition being examined in the methodology (e.g. price or margin), or that reasonably accurate adjustments can be made to eliminate the effect of any such differences."

Existing guidance on comparability

- The TPG describe five factors determining comparability:
  - Characteristics of property or services
  - Functional analysis (functions performed, assets used, risks assumed)
  - Contractual terms
  - Economic circumstances
  - Business strategies

Existing guidance on comparability

Chapter I of the TPG also discusses issues around:

- Recognition of the actual transactions undertaken
- Evaluation of separate and combined transactions
- Use of an arm's length range
- Use of multiple year data
- Losses
- The effect of government policies
- Intentional set-offs
- Use of customs valuations
- Use of transfer pricing methods

The OECD project on comparability

- Context : monitoring procedures of the TPG by Working Party No. 6 of the OECD Committee on Fiscal Affairs (i.e. the Working Party on the taxation of multinational enterprises).
- Invitation to comment posted in 2003 on:

  www.oecd.org/taxation
- Time frame

The OECD project on comparability

- How to apply comparability in practice
- All OECD transfer pricing methods
- Good faith taxpayer / administration
- Identify difficulties, propose workable solutions consistent with sound tax policy

Searching comparables: illustrative steps

Step 1 : Broad based analysis (e.g. industry analysis, analysis of value drivers…)

Step 2 : Determination of years to be covered

Searching comparables: illustrative steps

Step 3 : Review of the controlled transaction(s) in order to identify the relevant factors that will influence both the selection of the appropriate transfer pricing method(s) and the comparability analysis

Step 4: Review of existing internal comparables. Where necessary, decision to look for external ones.

Searching comparables: illustrative steps

Step 5 : Determination of available sources of information (including, but not limited to, commercial databases) and of their reliability

Step 6 : Selection of the relevant transfer pricing method(s) and definition of the relevant indicia (e.g. what net margin indicator in case of a TNMM).

Searching comparables: illustrative steps

- Step 7 : Identification of potential comparables: defining the key characteristics to be met by any uncontrolled transactions to be potentially comparable, on the basis of the relevant factors identified under step 3 and in accordance with the comparability standard established under paragraphs 1.19 to 1.35 of the TP Guidelines

Searching comparables: illustrative steps

- Step 8 : Determination of and making comparability adjustments, where and as needed.

- Step 9 : Interpretation and use of data, determination of the arm's length remuneration.

Searching comparables: illustrative steps

- Step 10: Implement support process. Install review process to ensure adjustment for material changes and document these processes

Issues currently discussed by the OECD

- Putting comparability analyses and searches for comparables into perspective (steps 1, 3)
- Information obtained after the transaction and retroactive adjustments (steps 2, 10)
- Use of multiple year data (steps 2, 9)
- Internal comparables (step 4)
- Determination of available sources of information and of their reliability (step 5)

Issues currently discussed by the OECD

- Aggregation of transactions (step 7)
- Uncontrolled transactions (step 7)
- Examining the five comparability factors (steps 3, 7)
- Selecting or rejecting third parties or third party transactions: degree of objectivity of the list of comparables (step 7)

Issues currently discussed by the OECD

- Determination of and making comparability adjustments where appropriate (step 8)
- Definition of the arm's length range, extreme results, loss-making comparables, use of statistical tools (step 9)
- Documenting the comparability analysis (step 10)

Putting comparability analyses and searches for comparables into perspective

- Comparability is wider than just a search for (external) comparables or than a mere systematic comparison of financial indicia
- Emphasis on quality and reasonableness
- Link the search for comparables in the comparability analysis (analysis of the conditions of the taxpayer's transactions)

Information obtained after the transaction and retroactive adjustments

- => Example of a price setting process:

- Preparation of Budget for 2006
- Between June and December 2005
- Available Information = 2004
- Relevance of data with a 2 year time lag ?

Information obtained after the transaction and retroactive adjustments

=> Contemporaneous outcome documentation:

- Testing arm's length outcome upon filing of the tax return
- Year-end adjustments
- What if both treaty partners have different approaches
- Differentiate from the use of hindsight

Information obtained after the transaction and retroactive adjustments

=> Data obtained / relating to years after the year of the transaction

- When
- What is use of hindsight

Use of multiple year data

- When / how to use multiple year data
- Interpretation of multiple year data : not to be confused with the use of statistical tools

Example:	2001	2002	2003	2004
Taxpayer's gross margin	25%	24%	27%	22%
Comparables' gross margin	[20-24%]	[27-30%]	[20-25%]	[18-24%]

Internal comparables

- In the TPG there is a general preference for internal comparables – where they exist and are valid – over external ones
- Reasons:
  - closer relationship to taxpayer's transaction,
  - better access to information,
  - less costly
- But: should satisfy the five comparability factors (beware of marginal transactions…)

Internal comparables

- Methods, specific transactions:
  - CUPs, Cost plus, Resale price
  - TNMM ?
  - Services, intangibles
- Documentation issue – avoid cherry picking
- Transactions between other parts of the MNE and third parties ?

Determination of available sources of information and of their reliability

- Informal and confidential information
  - Used by a taxpayer
  - Used by a tax administration in audits
  - Used in MAPs
- Commercial databases
- Public sources of information
- Foreign source or non domestic comparables

Determination of available sources of information and of their reliability

- Availability of information:
  - Markets where there is no or limited public information?
- Reliability of available information?
- What is the relevance of public information for transfer pricing purposes?
- Costs for taxpayers and administrations

Aggregation of transactions

- Recognise difficulty to find transactional information on third parties
- But: rules for aggregation of transactions
- In particular,

Aggregation of taxpayer's transactions (TPG 1.42)

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Use of third party consolidated data or data aggregated at company level

Uncontrolled transactions

- Highly integrated industries / markets
- Controlled transactions : to what extent can they provide useful information?
  - Cannot be the basis for an adjustment
  - Can provide useful information on the industry context (TPG 1.70)
- Use of consolidated data ? (when and subject to what adjustments)

Examining the five comparability factors

- Paragraphs 1.19 to 1.35 of the TPG
- In practice difficult to obtain comprehensive information on the 5 comparability factors in relation to third party comparables
- Perceived importance of missing information

Selecting or rejecting third parties or third party transactions: degree of objectivity of the list of comparables

- The "additive" and the "deductive approaches
- Auditability, reproducibility
- Need to document the criteria applied in the selection process

Determination of and making comparability adjustments where appropriate

- Importance of comparability adjustments
- Must be “reliable enough“
- Limited guidance in the TPG on when and how to make a comparability adjustment

Comparability adjustments

- Practical experience :
  - Accounting adjustments
  - Balance sheet adjustments
  - Others

Comparability adjustments

- Adjustments on data that does not satisfy a very high comparability standard
- Sophisticated adjustments
- Numerous adjustments
- Significant adjustments

Definition of the arm's length range, extreme results, loss-making transactions

- Definition of the arm's length range
  - Should extreme results be excluded ?
  - Loss-making comparables ?
- Effect of the « quality » of the set of comparables?

Support and review processes, documentation

- Monitoring: prices are not set once for ever
- Document the process:
  - Internal comparables
  - Selection of external comparables
  - Comparability adjustments

Particular difficulties in applying profit methods

- Is the use of profit methods a satisfactory mean to overcome some of the difficulties inherent to comparability?
  - Example : net versus gross margin ?
- Is the use of profit methods a satisfactory solution where no reliable enough comparables are found?
  - Example : apply a « profit split » with no comparables?

Particular difficulties in applying profit methods

- Would profit methods be more acceptable to (some) tax authorities if applied with stricter comparability standards?
  - Example : TNMM / CPM

The comparability project: preliminary conclusion

- This project is complex, important for taxpayers and tax administrations in the long term view
- Importance of private sector's contributions
- Questionnaire on profit methods to come

Questions and answers