



ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT



COMPARABILITY: PUBLIC INVITATION TO COMMENT ON A
SERIES OF DRAFT ISSUES NOTES

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CENTRE FOR TAX POLICY AND ADMINISTRATION

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As part of its procedures for monitoring the implementation of the 1995 Transfer Pricing Guidelines, Working Party No. 6 of the OECD Committee on Fiscal Affairs selected two areas to be considered in priority:

- Comparability issues encountered when applying the transfer pricing methods authorised by the 1995 TP Guidelines and
- The application of transactional profit methods (i.e., the transactional profit split methods and the transactional net margin method).

While recognising that the two projects are intrinsically linked, the Working Party started with a review of comparability issues in general. An open invitation to comment on comparability issues was released in 2003. Detailed contributions were received from the business community, most of which are available on the [OECD Internet site \(http://www.oecd.org/document/47/0,2340,en_2649_37427_2508655_1_1_1_37427,00.html\)](http://www.oecd.org/document/47/0,2340,en_2649_37427_2508655_1_1_1_37427,00.html). Comments are now invited on the attached series of draft Issues notes that was developed by Working Party No. 6, building on experience acquired by countries since the adoption of the Transfer Pricing Guidelines in 1995 and on comments received from the business community in response to the 2003 invitation.

A separate invitation to comment on issues related to profit methods was released on 28 February 2006.

Comments should be sent **by 30 November 2006**, preferably by e-mail, to Jeffrey Owens, Director of the OECD Centre for Tax Policy and Administration (Jeffrey.Owens@oecd.org) and copied to Caroline Silberztein, Head of the Transfer Pricing Unit, (Caroline.Silberztein@oecd.org).

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Putting a comparability analysis and search for comparables into perspective

A - A review of Article 9 of the OECD Model Tax Convention

1. In an effort to put the issue of comparability into perspective, it may be useful to refocus attention back to the origin of comparability analysis i.e. paragraph 1 of Article 9 of the OECD's Model Tax Convention. This review may prove to be a useful reminder of why a comparability analysis is needed and therefore emphasise the need for an approach that provides a qualitative analysis and is reasonably balanced in terms of the burden it creates for taxpayers and tax administration.

2. Paragraph 1 of Article 9 of the OECD Model Tax Convention is the authoritative statement of the arm's length principle:

“[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.” *[emphasis added]*

3. This paragraph is the foundation for comparability analyses because it introduces the need for a comparison between conditions made or imposed between associated enterprises and those which would be made between independent enterprises, as well as for a calculation of profits that would have accrued to the enterprise at arm's length. The reasoning in this paragraph is a two-stage one:

- First, a comparison of “conditions” made or imposed between associated enterprises with those which would be made between independent enterprises is necessary to determine *whether* a transfer pricing adjustment may be performed,
- Secondly, when special conditions that have been made or imposed between the associated enterprises have been identified, a *calculation* of the transfer pricing adjustment is made, by recalculating the profits which would have accrued to the enterprise in the absence of such conditions or adjusting the conditions to an arm's length level.

4. As indicated in Paragraph 2 of the Commentary on Article 9 of the Model Tax Convention:

“[...] The provisions of this paragraph [Paragraph 1 of Article 9] apply only if special conditions have been made or imposed between the two enterprises. No rewriting of the accounts of associated enterprises is authorised if the transactions between such enterprises have taken place on normal open markets commercial terms (on an arm's length basis).”

5. This point is reiterated in paragraph 2.3 of the Guidelines:

“The Commentary on Paragraph 1 of Article 9 indicates that paragraph 1 authorizes a tax administration ‘for the purpose of calculating tax liabilities [to] re-write the accounts of the [associated] enterprises if as a result of the special relations between the enterprises the accounts do not show the true taxable profits arising in that State.’ The ‘true taxable profits’ are those that would have been achieved in the absence of the conditions that are not arm’s length. The Commentary emphasizes that the Article does not apply where transactions have occurred on ‘normal open market commercial terms (on an arm’s length basis)’; accounts may be rewritten ‘only if special conditions have been made or imposed between the two enterprises.’ Thus, the issue under Article 9 is whether the conditions in the commercial or financial relations of associated enterprises are arm’s length or whether instead one or more ‘special conditions’ exist (i.e. conditions that are not arm’s length).”

6. Thus, the primary drivers for doing a comparability analysis are for taxpayers to determine how transfer prices should be established and for tax administrations to determine *whether* a transfer pricing adjustment may be made. The comparison required under the first part of paragraph 1 of Article 9 is a comparison of conditions that is broader than a mere comparison of prices or margins. While prices are obviously a critical condition to a transaction, they are not the only one.

7. Paragraph 2.5 of the Guidelines however indicates that:

“The most direct way to establish whether the conditions made or imposed between associated enterprises are arm's length is to compare the prices charged in controlled transactions undertaken between those enterprises with prices charged in comparable transactions undertaken between independent enterprises. This approach is the most direct because any difference in the price of a controlled transaction from the price in a comparable uncontrolled transaction can normally be traced directly to the commercial and financial relations made or imposed between the enterprises, and the arm's length conditions can be established by directly substituting the price in the comparable uncontrolled transaction for the price of the controlled transaction. However, there will not always be comparable transactions available to allow reliance on this direct approach alone, and so it may be necessary to compare other less direct indicia, such as gross margins, from controlled and uncontrolled transactions to establish whether the conditions between associated enterprises are arm's length. [...]”

8. In effect in practice, many tax administrations and practitioners rely primarily on a comparison of prices or margins in order to determine the arm’s length nature of a transaction. It might be worth however noting that:

- A comparison of the conditions surrounding the transaction under review, including price, is needed to justify an adjustment under Article 9 of the MTC,
- Any proposed comparison of prices or margins should be supported with documentation allowing a broader understanding of all the conditions of the transaction being reviewed (hence the importance of the five comparability factors identified in the Guidelines);
- Where a comparison of conditions is performed and where the outcome of such a comparison is that no conditions were made or imposed which differ from those which would be made between independent enterprises, there is no requirement under Article 9 of the MTC to proceed with a comparison of margins;

- Where it is found that conditions were made or imposed which differ from those which would be made between independent enterprises, the determination of the quantum of the transfer pricing adjustment is based on a determination of the profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued. This determination can be made using any of the OECD transfer pricing methods, subject to its being appropriate for the facts and circumstances of the case and consistent with the hierarchy of methods that is currently in the Guidelines.

9. Most OECD countries have developed transfer pricing documentation requirements that are intended to encourage taxpayers to demonstrate that their transfer prices are in accordance with the arm's length principle and to provide tax administrators with the necessary information to decide whether an adjustment may be made under Article 9 and where this is the case to determine the quantum of said adjustment. In practice, a typical transfer pricing documentation will necessarily include a review of the conditions of the controlled transactions. Because the analysis of the conditions of a transaction is needed in order to determine whether a transfer pricing adjustment may be made, some countries may require it as part of a risk assessment phase. A comparison of financial outcomes to determine profits can also be required, at a point in time and to an extent that vary depending on the domestic system. Specifically, depending on countries' domestic systems, such calculation may be required for all controlled transactions (e.g. upon filing of the return) or only for those transactions which have not passed the test set in the first part of paragraph 1 of Article 9 and for which an adjustment is considered (e.g. during the audit phase).

B - Linking the search for comparables and comparability analysis

10. Linking the search for comparables and comparability analysis is topical since many actual experiences described to date have noticed a disconnect between these two processes. This disconnect may become more frequent as searches for comparables increasingly often rely on external comparables searched on a database, with an observed tendency to focus on comparisons of financial indicia.

11. By definition a comparison implies examining two terms: the controlled transaction under review and the uncontrolled transactions that are regarded as potentially comparable. The search for comparables is only part of the comparability analysis. It should neither be confused with nor be separated from the comparability analysis.

12. The note "Selecting or rejecting third parties or third party transactions: degree of objectivity of the list of external comparables", establishes a list of ten typical sequential steps for searching for information on comparable transactions. Although the note states that the order of the steps is only illustrative and that the process is not linear, it does begin to identify how to go about conducting a comparability analysis as opposed to just describing potentially relevant factors.

13. The search for information on potentially comparable transactions and the process of identifying comparables is dependent upon prior analysis of the taxpayer's controlled transaction and of the relevant comparability factors. A methodical, consistent approach should provide some continuity or linkage in the whole analytical process, thereby maintaining a constant relationship amongst the various steps: from the preliminary analysis of the conditions of the controlled transaction, to the conditions of transactions between the unrelated parties, through to the potential search for comparables and ultimately a conclusion.

14. In this respect, the first step i.e. the "broad-based analysis" is an essential one. The broad-based analysis can be defined as an analysis of the industry, value drivers, competition, economic and regulatory factors and other elements to better understand the taxpayer and its environment but not yet within the

context of looking at the specific transactions in question. This step helps understand the conditions of the taxpayer's controlled transaction as well as the conditions of the uncontrolled transactions to be compared.

C - Taking account of the burden and costs involved in comparability analyses

15. One question that arises when putting the need for comparability analyses into perspective is the extent of the burden and costs that should be borne by a taxpayer to obtain detailed information on third parties. This issue was raised by several business commentators. It is recognised that the cost of information can be a real concern, especially for small to medium sized operations. Paragraphs 5.6, 5.7 and 5.28 of the Guidelines currently contain explicit recognition of the need for a reasonable application of the requirement to document comparability:

“5.6 In considering whether transfer pricing is appropriate for tax purposes, it may be necessary in applying principles of prudent business management for the taxpayer to prepare or refer to written materials that would not otherwise be prepared or referred to in the absence of tax considerations [...]. When requesting submission of these types of documents, the tax administration should take great care to balance its need for the documents against the cost and administrative burden to the taxpayer of creating or obtaining them. For example, the taxpayer should not be expected to incur disproportionately high costs and burdens [...] to engage in an exhaustive search for comparable data from uncontrolled transactions if the taxpayer reasonably believes, having regard to the principles of this Report, either that no comparable data exists or that the cost of locating the comparable data would be disproportionately high relative to the amounts at issue. [...]”

“5.7 Thus, while some of the documents that might reasonably be used or relied upon in determining arm's length transfer pricing for tax purposes may be of the type that would not have been prepared or obtained other than for tax purposes, the taxpayer should be expected to have prepared or obtained such documents only if they are indispensable for a reasonable assessment of whether the transfer pricing satisfies the arm's length principle and can be obtained or prepared by the taxpayer without a disproportionately high cost being incurred. The taxpayer should not be expected to have prepared or obtained documents beyond the minimum needed to make a reasonable assessment of whether it has complied with the arm's length principle. [...]”

“5.28 Taxpayers should make reasonable efforts at the time transfer pricing is established to determine whether the transfer pricing is appropriate for tax purposes in accordance with the arm's length principle. [...] However, the extensiveness of this process should be determined in accordance with the same prudent business management principles that would govern the process of evaluating a business decision of a similar level of complexity and importance [...]”

16. In practice, this means that it may be reasonable for a taxpayer to devote relatively less effort to find detailed comparable third party information supporting relatively small controlled transactions than for large transactions. In this proportionality standard, “small controlled transactions” may be measured relative to the size of the business. However, the degree of required compliance effort must also be assessed against the absolute size of the controlled transactions, so that it would be reasonable for taxpayers to devote proportionally more effort to find comparables for larger controlled transactions, regardless of their relative importance in the taxpayer's business. Based on this concept of reasonable assessment, there are also arguments to consider that for simple transactions that are carried out in a stable environment and the characteristics of which remain the same or similar, a detailed comparability analysis might not need to be reanalysed every year with a detailed functional analysis, as long as the financial information on comparables is updated and its relative comparability is established annually, in contrast to what is generally needed for new transactions, complex transactions or transactions performed in a

changing environment. Taxpayers should be encouraged to set up a process to monitor and review their transfer prices, taking into account the size of the transactions, their complexity, level of risk involved, and whether they are performed in a stable or changing environment.

17. Such a practical approach would conform to a pragmatic risk assessment strategy. In this respect, the concept of “prudent business management” may be worth clarifying in the Guidelines. In particular, a reference to the “prudent business management” principle could be made explicit in Chapter I of the Guidelines when addressing the comparability analysis as well as in the Glossary.

18. In the domain of transfer pricing there is a particular need to balance prescriptive and consistent rules for all taxpayers with a level of reasonableness and judgment. The size and diversity of taxpayers is growing in scope. The entrance of small to medium sized enterprises into the area of transfer pricing and the number of smaller transactions is ever increasing. Although the OECD considers that the arm’s length principle should equally apply to small and medium sized enterprises, pragmatic solutions may be promoted, in order to make it possible to find a reasonable response to each transfer pricing case.

19. The number of truly unique transactions and scenarios where finding comparables may be difficult, if not impossible, has been increasing. In addition, some markets have a limited access to public information on third party transactions. However there is no discussion at this stage of the Guidelines of alternatives if there are likely no comparables to be found, with the possible exception of a profit split.

20. In these cases, the application of the arm’s length principle might eventually resort to a prudent business management principle test, where one would try to create the theoretical arm’s length environment by asking the question, whether the conditions of the controlled transaction under review are consistent with what a reasonable independent party *would have done* if confronted with the same opportunities or set of circumstances and quantify the adjustment by reference to profits that *would have* accrued at arm’s length. On the other hand, both taxpayers and tax administrations need information to do a transfer pricing analysis and the prudent business management principle should not have the effect of reducing the availability of information that can be used in a transfer pricing analysis or to reduce the ability of a tax administration to make an adjustment.

21. These developments necessitate a solution that would hopefully satisfy both tax administrations and taxpayers. It seems as though the rather open wording of the Model Tax Convention may present an opportunity to provide for this balance in the Guidelines.

D - Preliminary Conclusion

22. Comparability analyses are grounded in paragraph 1 of Article 9 of the Model Tax Convention and are essential to the application of the arm’s length principle.

23. They should not be limited to a mere search for comparables or a mere comparison of financial indicia. Searches for comparables should not be disconnected from the other steps of the comparability analysis, in particular the review of the conditions of the controlled transactions and the determination of the relevant comparability factors.

24. Putting comparability analyses and searches for comparables into perspective should serve the dual objective of putting greater emphasis on the quality of the analyses rather than on mechanical comparisons of financial indicia and reaching a standard that is reasonable and balanced in terms of the burden created for taxpayers and administrations. In this respect, the concept of “prudent business management” may be worth clarifying in the Guidelines.

Timing issues in comparability

1. There are timing issues in comparability with respect to the time of origin, collection and production of information on comparability factors and comparable uncontrolled transactions that are used in a comparability analysis. Different practices exist with respect to all of these issues.

- One issue relates to the point in time when information on comparable uncontrolled transactions is collected either by the taxpayer or by a tax administration.
- Another issue is whether information on uncontrolled transactions that is used in a comparability analysis always needs to pertain to the same year as the taxpayer’s controlled transaction under review, or whether – and if so in what circumstances and to what extent – information pertaining to years prior or subsequent to the year of the taxpayer’s controlled transaction can be used.
- A third issue relates to the point in time when information collected is produced by the taxpayer to the tax administration.

2. While the first and third issues are to a large extent domestic procedural issues, there is obviously a link between the first two issues and comparability analyses as the extent of available information pertaining to a given year can depend on the timing of collection. This note concentrates on the first two issues to the extent they are linked to comparability analysis. A discussion of domestic procedural requirements for developing, producing or reviewing transfer pricing documentation or of penalties is not within the scope of this paper.

A. Existing guidance

3. Chapter V of the Transfer Pricing Guidelines deals with the issue of documentation. In particular, paragraphs 5.3, 5.4, 5.5, 5.9 and 5.14 provide indications with respect to timing issues.

4. Paragraph 5.3 states:

“Each taxpayer should endeavour to determine transfer pricing for tax purposes in accordance with the arm’s length principle, based upon information reasonably available at the time of the determination. Thus, a taxpayer ordinarily should give consideration to whether its transfer pricing is appropriate for tax purposes before the pricing is established. For example, it would be reasonable for a taxpayer to have made a determination regarding whether comparable data from uncontrolled transactions are available. The taxpayer also could be expected to examine, based on information reasonably available, whether the conditions used to establish transfer pricing in prior years have changed, if those conditions are to be used to determine transfer pricing for the current year.”

5. Paragraph 5.4 states in part:

“[...] It would be reasonable for tax administrations to expect taxpayers when establishing their transfer pricing for a particular business activity to *prepare* or to *obtain* such materials regarding the nature of the activity and the transfer pricing, and to retain such material for production if necessary in the course of a tax examination. [...] Note, however, that there should be no contemporaneous obligation at the time the pricing is determined or the tax return is filed to *produce* these types of documents or to prepare them for review by a tax administration.” [*emphasis added*]

6. Paragraph 5.5 states in part:

“Because the tax administration’s ultimate interest would be satisfied if the necessary documents were submitted in a timely manner when requested by the tax administration in the course of an examination, the document storage process should be subject to the taxpayer’s discretion.”

7. Paragraph 5.9 states:

“Tax administrations also should limit requests for documents that became available only after the transaction in question occurred to those that are reasonably likely to contain relevant information as determined under principles governing the use of multiple year data in Chapter I or information about the facts that existed at the time the transfer pricing was determined. In considering whether documentation is adequate, a tax administration should have regard to the extent to which that information reasonably could have been available to the taxpayer at the time transfer pricing was established.”

8. Paragraph 5.14 lays out the benefits to taxpayers of adequately documenting their transactions:

“Taxpayers should recognise that notwithstanding limitations on documentation requirements, a tax administration will have to make a determination of arm’s length transfer pricing even if the information available is incomplete. As a result, the taxpayer must take into consideration that adequate record-keeping practices and the voluntary production of documents can improve the persuasiveness of its approach to transfer pricing. This will be true whether the case is relatively straightforward or complex, but the greater the complexity and unusualness of the case, the more significance will attach to documentation.”

9. Paragraph 5.15 states:

“Tax administrations should limit the amount of information that is requested at the stage of filing the tax return. At that time, no particular transaction has been identified for transfer pricing review. It would be quite burdensome if detailed documentation were required at this stage on all cross-border transactions between associated enterprises, and on all enterprises engaging in such transactions. Therefore, it would be unreasonable to require the taxpayer to submit documents with the tax return specifically demonstrating the appropriateness of all transfer price determinations. The result could be to impede international trade and foreign investment. Any documentation requirement at the tax return filing stage should be limited to requiring the taxpayer to provide information sufficient to allow the tax administration to determine approximately which taxpayers need further examination.”

B. Timing of collection of information by the taxpayer

10. A taxpayer may try to identify third party comparables to support its future transfer pricing policy, e.g. as a routine exercise linked with the budgetary process, or as part of an APA negotiation. In other cases, a comparability study may be carried out to verify the consistency with the arm's length principle of prices actually charged for transactions already completed. Such an ex post facto verification may take place when the year-end tax return is filed and/or at a later stage in the course of an audit by the tax authorities. In some circumstances, it can be advantageous for taxpayers to demonstrate that they have made their best efforts to comply with the arm's length principle at the time the intra-group transactions and transfer pricing policy were set up. In other circumstances, taxpayers might test the actual outcome of the controlled transactions at the year-end and perform year-end adjustments when actual results fall out of the range of comparable data available at that point.

B-1 Illustration of differences between the approaches

11. Assume, for example, that a taxpayer has computed the prices of its 2005 intra-group transactions on the basis of data collected at the end of 2004. Typically such data would comprise market and product information available at the end of 2004 and internal comparables where they exist. It could be completed by a search for external comparables but in such a case available third party information might only pertain to 2002 and 2003. Assume that in 2006, when preparing its 2005 return, the taxpayer updates its comparability study and obtains third party data pertaining to 2004 and/or 2005 that is significantly different from the data collected on prior years. As a result, the profit or margin which was used as the basis for the calculation of the transfer prices in 2005 – based on the initial search for comparables – is now found to fall out of the updated range. Alternatively, or in addition, assume that in 2008, when the taxpayer's 2005 return is being audited, a comparability study reveals third party data pertaining to 2005 which has become available in the interim and which suggests that the transfer prices originally calculated or reported for 2005 fall outside the updated range.

12. There is very limited guidance in the Guidelines on the question of whether the 2005 transactions should be retroactively adjusted:

- One possible approach is to consider that the pricing of the 2005 transactions has been set in arm's length conditions, on the basis of information available at the time terms and conditions were determined. The rationale for taking this approach seems to be the belief that an independent party would generally not agree to retroactively amend the pricing of transactions previously negotiated and already completed because of ex post facto third party information, especially when the 2005 statutory books are closed (unless the terms and conditions of such a retroactive adjustment are agreed upon in advance). This argument has been raised in particular in countries where the evaluation of the pricing of a transaction for transfer pricing purposes is linked to the pricing of the transaction for other purposes (legal accounting).
- Another possibility is to regard the new set of results as indicating that the pricing of 2005 transactions was not at arm's length, since the outcome of said pricing is not in line with the outcome of comparable uncontrolled transactions. Adjustments of transfer prices reported for tax purposes would accordingly be required in the tax return filed for 2005 (both downward and upward adjustments).
- Finally another approach is to re-assess the taxpayer's basis if the outcome of the updated search reflects higher profits or margins than actually reported by the taxpayer, without

allowing the taxpayer to retroactively amend its return if the outcome of the updated search is lower than profits or margins it actually reported.

13. To the extent that these differences are reflected in countries' actual practices, difficulties are created for taxpayers when they develop a world-wide transfer pricing policy.

B-2 Documenting the process that led to the establishment of the transfer prices, prior to the transaction being undertaken

14. As indicated at Paragraph 5.3 of the Guidelines, "each taxpayer should endeavour to determine transfer pricing for tax purposes in accordance with the arm's length principle, based upon information reasonably available *at the time of the determination* [emphasis added]. Thus, a taxpayer ordinarily should give consideration to whether its transfer pricing is appropriate for tax purposes *before the pricing is established* [emphasis added]." Accordingly, a comparability analysis might be appropriate at the time the transactions are organised by the taxpayer.

15. By contrast to the approach described in section B-3 below, this approach may not rely on a comparison with the *outcome* of actual uncontrolled transactions, but may rather give more importance to a comparison of prices set in accordance with ex-ante documentation. This is logical for an analysis performed at a point in time when the outcome of the transaction is still unknown. This is consistent with Article 9 of the Model Tax Convention, which requires a comparison of the *conditions made or imposed* between the two related enterprises in respect of a transaction. In some circumstances, however, a tax administration might find it necessary to test also the *outcome* of the transaction and would therefore combine such an approach with requests to provide further transfer pricing analysis at the time of the filing of the return and/or in case of an examination (see B-3 below).

16. When this approach is followed, it will be valuable to take into account the information (which would usually extend beyond external or third party data) that was available to the prudent business manager at the time that manager would have had to make such pricing decisions. As a result, documentation prepared in accordance with the prudent business manager principle at the time the transactions are organised could include market information, internal comparables where they exist and could be completed by external comparables where appropriate.

B-3 Documentation at the time of the filing of the tax return

17. In some circumstances, taxpayers follow an alternative approach. In practice, this approach looks at transactions undertaken in year N and compares them with year N comparable data, with the analysis typically undertaken a few months after the close of year N. The determination of whether the transactions were undertaken at arm's length is made (and any adjustment to prices actually charged is reflected) with the tax filing. In this approach, or year-end compensating adjustment, the taxpayer's analysis is typically performed before an administrative examination typically begins and this practice should accordingly be distinguished from retroactive adjustments described in Section C below.

18. In these circumstances, the most valuable documentation for both the taxpayer and the revenue administration is documentation supporting the application of the arm's length principle which is brought into existence up to the time of lodgement of the relevant tax return.

19. By contrast to the approach described in section B-2 which focuses on prices set in accordance with ex-ante documentation, this approach puts greater emphasis on testing the *outcome* of a taxpayer's

controlled transactions. This of course does not mean that other types of information (functional analysis and comparability criteria in particular) can be overlooked.

20. This approach can be adopted for pragmatic reasons. It is not intended to deny upfront pricing practices and documentation where such upfront pricing practices and documentation can be properly implemented and may also be used to complement this practice. Neither is it intended to allow injudicious use of subsequent data.

21. In other circumstances, however, this approach would not be a practical approach because the usual time lag to obtain third party information could be much more than one year. Accordingly, information available at the time of the filing of the return might not relate to the year in which the controlled transaction was undertaken. Feasibility of such an approach can be influenced, for example, by:

- Whether at the time of the filing of the tax return for a given year, third party financial information pertaining to that particular year is available; and
- What the flexibility is for tax figures to differ from actually transacted amounts and from figures reported for legal accounting purposes.

B-4 Cases involving double taxation

22. As indicated in paragraphs 4.38 and 4.39 of the Guidelines,

“[A]t least one OECD Member country has a procedure that may reduce the need for primary adjustments by allowing the taxpayer to report a transfer price for tax purposes that is, in the taxpayer’s opinion, an arm’s length price for a controlled transaction even though this price differs from the amount actually charged between the associated enterprises. This adjustment, sometimes known as a ‘compensating adjustment’, would be made before the tax return is filed. [...]

However, compensating adjustments are not recognised by most OECD countries, on the grounds that the tax return should reflect the actual transactions.”

23. The issue of double taxation may arise where a related party transaction takes place between two associated enterprises where different approaches to documentation and analysis have been applied. As indicated in paragraph 4.39 of the 1995 TP Guidelines, “if compensating adjustments are permitted in the country of one associated enterprise but not permitted in the country of the other associated enterprise, double taxation may result because corresponding adjustment relief may not be available if no primary adjustment is made.” Competent authorities are encouraged to use their best efforts to resolve any double taxation which may arise from different country approaches to year-end adjustments and that may be submitted to them under a Mutual Agreement Procedure (Article 25 of the OECD Model Tax Convention). Regardless of the approach used, discussions between competent authorities are likely to be assisted by the provision of as much information as possible relevant to determining comparability.

C. Ex post facto review of transfer prices: use of information on comparability factors and comparable uncontrolled transactions that is obtained at a significantly later date, e.g. during an examination which takes place two or three years after the transaction

24. In some countries, depending on domestic documentation requirements, a full comparability analysis (i.e. a review of the five comparability factors as well as a search for internal and/or external comparables) might be required at the time of the filing of the return. In some other countries, such a full comparability analysis might only be required upon request at a later stage, e.g. during the audit, possibly limited to those transactions that have been identified by the tax authorities for further examination.

25. Requiring a taxpayer to produce documentation at the time of the audit does not mean that all documentation will be prepared at this moment. It can be expected that some elements such as market analyses used in the process of establishing transfer prices and intra-group agreements describing the conditions of the transaction (when such agreements are formalised in writing) should be in existence at the time of the transaction. The nature of the documentation requirement at the time of the audit might therefore be threefold:

- Requirement for the taxpayer to have available for timely production information that is already in existence, including information that was used in setting prices or testing outcomes (depending on the approach taken in domestic legislation),
- Requirement to complete such information where the documentation provided is not sufficient to support the prices used,
- Requirement to further develop the transfer pricing analysis on some particular transactions identified in the context of the audit. This further developed documentation might include a search for external comparables in cases where no internal comparables were identified and/or where such a search for external comparables is not required at an earlier stage (e.g. where there is no domestic requirement for such a search to be performed at the time of the filing, see paragraph 5.15 of the Guidelines).

26. Information that could reasonably have been obtained by the taxpayer either at the time of the price-setting, or of the filing of the tax return or of the outcome-testing of its controlled transactions (depending on the applicable domestic requirements), but was not collected or used at that time can generally be used at a later stage e.g. during the audit. This might be the case for instance where comparables collected by the taxpayer at the time of the transaction do not satisfy the five comparability factors, or do not account for a significant change in the business environment that has affected the taxpayer's transactions during the year concerned.

27. It may be expected that when analyses are performed at different times using different information, a transfer pricing adjustment may be found to be appropriate, even where the taxpayer has met the documentation requirements for each period of analysis. When a taxpayer has made reasonable efforts to and/or has properly identified, used and documented a price-setting process that meets the arm's length principle and a transfer pricing adjustment is subsequently found to be necessary, proper mechanisms should be in place to allow appropriate adjustments and limit risks of double taxation and penalties.

28. A different but related question concerns the use of hindsight by either a taxpayer or a tax administration. Although paragraph 1.51 of the Guidelines recommends that "care must be taken by tax administrations to avoid the use of hindsight", there is no definition in the Guidelines of what constitutes

hindsight and countries may have different practices in that respect. This is an issue on which further work might be done by the Working Party.

D. Time of origin of comparable uncontrolled transactions

D-1 Information pertaining to comparable uncontrolled transactions that were undertaken or carried out during the same period of time as the taxpayer's controlled transaction, in other words, information on contemporaneous transactions

29. For some countries the most reliable source of information is information relating to the terms and conditions of the controlled transaction under review and the arm's length terms and conditions of comparable uncontrolled transactions undertaken at the same time of the controlled transaction, whether or not collected at the time of the controlled transaction. In this note "contemporaneous uncontrolled transactions" are defined as comparable uncontrolled transactions undertaken or carried out during the same period of time as the taxpayer's controlled transaction under review, whether or not information on said transactions is collected at that time.

30. Some relevant information on contemporaneous uncontrolled transactions may not become publicly available until after the completion of the transactions or after the taxpayer's filing date. For instance, in the case of external comparables, the details and outcomes associated with those transactions may not be publicly reported until after the filing due date, and obviously could not be expected to be available to the taxpayer at the time of the transaction or filing date. This information would nevertheless relate to comparable transactions that are contemporaneous to the controlled transactions so as to reflect similar economic conditions. In such a situation, where outcomes information is not available at the time that transfer prices are required to be set, outcomes from transactions in prior years and information on market conditions may be the only reliable information available. One important question is to what extent and in what circumstances such information (on the outcomes of contemporaneous uncontrolled transactions that became available at a later date, or on the outcomes of transactions from prior years) can be used by taxpayers and tax administration in making transfer pricing adjustments.

31. In principle, contemporaneous uncontrolled transactions should provide the most reliable comparables because they can be expected to have been carried out in an economic environment that is the same as or similar to the economic environment of the taxpayer's controlled transaction. This principle might seem obvious but it however gives rise to a couple of comments and may warrant a few exceptions. As always in transfer pricing one should exercise judgment in determining what period of time provides the best comparables.

32. First, while it is obviously practical to make year-by-year comparisons, economic circumstances cannot be assumed to change overnight at the end of a tax year. While "contemporaneous" means during the same period of time, it does not necessarily mean during the same tax year. Therefore, while in the vast majority of cases "information on contemporaneous transactions" will be understood for practical reasons as information on transactions that were undertaken or carried out during the same year as the year of the taxpayer's controlled transaction, there may be cases where the year is not the most relevant reference. For instance, depending on the industry concerned and of the circumstances of the case, a transaction that took place in November 2001 might be more comparable to a transaction in the same industry that took place in January 2002 than to one that took place in January 2001.

33. Secondly, where the transactions being compared are subject to cycles (product cycles or business cycles), it is desirable to the extent possible to make sure that the transactions being compared are at least broadly at the same point in the cycle. This is one reason for the use of multiple year data as discussed in a separate note "Use of multiple year data". Where the taxpayer's controlled transaction and the comparable

uncontrolled transaction are not at the same point in the cycle, there is a question as to whether the comparison can or should rather be made with a transaction that took place at the same point in the cycle, even though not during the same calendar or fiscal year.

34. For some countries the most reliable source of information to apply to the analysis of arm's length pricing is contemporaneous information defined as all relevant information relating to the terms and conditions of the controlled transaction under review and the arm's length terms and conditions of comparable uncontrolled transactions undertaken at the same time of the controlled transaction, whether or not collected at the time of the controlled transaction.

35. In principle, contemporaneous information as defined in the above paragraph may be expected to provide the most reliable information to apply in a comparability analysis because the information relates to conditions under which unrelated parties undertook transactions in an economic environment that is the same as or similar to the economic environment of the taxpayer's controlled transaction.

D-2 The use of data relating to years subsequent to the year of the transaction

36. Paragraph 1.51 of the 1995 TP Guidelines provides the following indications:

“Data from years following the year of the transaction may also be relevant to the analysis of transfer prices, but care must be taken by tax administrations to avoid the use of hindsight. For example, data from later years may be useful in comparing product life cycles of controlled and uncontrolled transactions for the purpose of determining whether the uncontrolled transaction is an appropriate comparable to use in applying a particular method. Subsequent conduct by the parties will also be relevant in ascertaining the actual terms and conditions that operate between the parties.”

37. The issue of hindsight is briefly touched upon at paragraph 28 above.

38. Where the same or similar transactions are carried out by a taxpayer during more than one year, information from a year subsequent to the year when the transaction is first established might be necessary to re-evaluate transfer prices applicable to the following years. In other words, it would not be reasonable for taxpayers to determine their transfer prices once and for ever. Transfer prices should be reviewed from time to time as needed by normal business considerations. This is likely to be on an annual basis in many businesses, but might be more often in businesses with short economic cycles, or less often in a very stable industry. Major events affecting the industry could also require exceptional adjustments, e.g. as has been the case by the end of 2001 for some industries. This is consistent with the last sentence of paragraph 5.3 of the Guidelines (“The taxpayer also could be expected to examine, based on information reasonably available, whether the conditions used to establish transfer pricing in prior years have changed, if those conditions are to be used to determine transfer pricing for the current year”).

39. In short, taxpayers are expected to monitor and review the conditions of their international related party transactions where such transactions are significant or complex, in order to account for changes in economic realities. Independent enterprises acting at arm's length would generally be willing to try to re-negotiate the terms of their significant contracts when such terms no longer fit with their best interests.

E - Other issues

40. There are wider issues in relation to transfer pricing documentation requirements in terms of content and of process for establishing such documentation, as well as with respect to the link between transfer

pricing documentation and penalties. These wider issues are not within the scope of the review of comparability. They may be discussed when the Working Party revisits Chapter V of the Guidelines.

41. In addition, business representatives who have responded to the OECD invitation to comment have drawn attention to the difficulties caused by transfer pricing adjustments in areas beyond transfer pricing, e.g. VAT, customs, excise taxes, and regulatory requirements (e.g. price of drugs) and some of them urged the OECD to provide further guidance on these issues. Delegates have noted that in particular the impact of transfer pricing adjustments on VAT and customs duties is becoming an increasingly important issue in many OECD countries. Accordingly this issue should be added to the Working Party's Catalogue of Issues for consideration at a later stage.

Internal comparables

A – Definition – Existing guidance

1. The Guidelines do not provide a direct definition of “internal comparables” nor specifically use such an expression. However, whenever the Guidelines make a reference to “comparable uncontrolled transactions” they are implicitly referring to both internal and external comparables, that is to say comparable transactions between the taxpayer and a non-related party or between an independent enterprise and a non-related enterprise. This distinction is found in particular in the description of the resale price, cost plus and transactional net margin methods as follows.
2. When describing the resale price method, paragraph 2.15 of the Guidelines states that “the resale price margin of the reseller in the controlled transaction may be determined by reference to the resale price margin that the same reseller earns on items purchased and sold in comparable uncontrolled transactions. *Also* [emphasis added], the resale price margin earned by an independent enterprise in comparable uncontrolled transactions may serve as a guide”.
3. When applying the resale price method, the controlled transaction under review is the purchase by the taxpayer from a related party of products for resale to third parties. An internal comparable when applying the resale price method would be a purchase transaction by the same taxpayer from an unrelated party of comparable products in comparable conditions for resale to third parties.
4. For the cost plus method, paragraph 2.33 indicates that “the cost plus mark up of the supplier in the controlled transaction should *ideally* [emphasis added] be established by reference to the cost plus mark up that the same supplier earns in comparable uncontrolled transactions. In addition, the cost plus mark up that would have been earned in comparable transactions by an independent enterprise may serve as a guide.”
5. In applying the cost plus method, the controlled transaction under review is generally the provision to a related party of goods manufactured by the taxpayer or services supplied by the taxpayer. An internal comparable in applying the cost plus method would be the provision by the same taxpayer to third parties of comparable products or services in comparable conditions.
6. With respect to the transactional net margin method, paragraph 3.26 notes that: “the transactional net margin method examines the net profit margin relative to an appropriate base (e.g. costs, sales, assets) that a taxpayer realizes from a controlled transaction [...]. This means in particular that the net margin of the taxpayer from the controlled transaction [...] should *ideally* [emphasis added] be established by reference to the net margin that the same taxpayer earns in comparable uncontrolled transactions. Where this is not possible, the net margin that would have been earned in comparable transactions by an independent enterprise may serve as a guide.”

B - Practical experience

7. In practice there is an increasing use of external comparables (in particular using commercial databases) rather than internal ones. According to some business commentators, one reason would be the increasing integration of multinational enterprises, with the consequence that some categories of transactions are less likely to be found between enterprises that belong to a multinational group and unrelated parties. This however does not mean that internal comparables never exist.

8. Another reason could be that the convenience of some external data sources may undermine a properly rigorous transfer pricing analysis including the determination and use of internal comparables. As a commentator from the business community pointed out in response to the comparability questionnaire, “the possession or acquisition of expensive commercial databases creates the need for usage and payback of such assets.”

C – General preference for internal comparables over external comparables: rationale and limits

9. The above quoted paragraphs (paragraphs 2.15, 2.33 and 3.26) indicate a general preference for internal comparables (where they exist and are reliable enough) over external ones. The main reason for this general preference is that internal comparables are likely to have a more direct and closer relationship to the transaction under review (see paragraph 1.70 of the Guidelines). First, because by comparing two purchase transactions carried out by the same buyer (in the case of a resale price method for instance) or two sales transactions carried out by the same supplier (in the case of a cost plus method for instance), the quality of the comparability analysis is likely to be enhanced¹. Secondly, because by comparing the gross or net margins that the same taxpayer earns with a related and an unrelated party, the financial analysis is likely to be both easier and more reliable as it will presumably rely on identical accounting standards and practices. In addition, access to information on internal comparables is both more complete and less costly.

10. As a general principle, the Working Party considers that practitioners should first examine whether internal comparables exist before starting a search for external comparables. See separate note on “Determination of available sources of information and of their reliability”.

11. However, reliable internal comparables are not always available. While comparisons should “ideally” be made with internal comparables, external comparables should generally be used wherever internal comparables either do not exist or do not provide reliable enough information. This is consistent with the existing language in paragraphs 2.15, 2.33 and 3.26 of the Guidelines.

12. In effect, the general preference for internal comparables does not mean that any transaction between a taxpayer and an unrelated party can be regarded as a reliable comparable. Internal comparables where they exist must satisfy the five comparability factors in the same way as external comparables. Guidance on comparability adjustments also applies to internal comparables. For instance, assume the controlled transaction under review is the manufacturing and sale by a taxpayer to a foreign related party of one million units of a given product per year representing 90% of the taxpayer’s sales. Assume that during the year concerned, the same taxpayer also makes a marginal sale of 10 units of the same product to an unrelated party. The difference in volumes between both transactions is likely to materially affect comparability. A proper effort should be made to adjust that difference. If, in spite of that effort, such a

¹ See paragraphs 2.20, 2.21, 3.26, 3.34 and 3.39 of the Guidelines which contain some recognition of a possibly less reliable outcome when external comparables rather than internal ones are used.

difference cannot be reliably adjusted, the transaction between the taxpayer and its unrelated customer will not be a valid comparable and a search for external comparables may have to be performed.

13. In short, the general preference for internal comparables over external ones is grounded in the potential advantages internal comparables are likely to present as described in paragraph 9 above. It is not however an absolute hierarchy and it has to be appreciated on a case by case basis in light of the objective to find the best available and reliable comparables.

D - Possible developments

D-1 Internal comparables and transfer pricing methods

14. Beyond the indications of a general preference for internal comparables in the description of the resale price, cost plus and transactional net margin methods (see Section A above), there is no discussion of internal comparables in Chapter I of the Guidelines that would apply to all OECD transfer pricing methods. It might be useful to provide in Chapter I a definition of internal and external comparables and clarify the meaning, reasons and limits of the general preference for internal comparables.

15. In addition, some further comments on the use of internal comparables when applying the comparable uncontrolled price or transactional net margin methods might be useful as discussed below.

(a) Comparable uncontrolled price (“CUP”)

16. There is no indication of a general preference for internal comparables over external ones in the Guidelines’ description of the comparable uncontrolled price method. The general preference for internal comparables described in section C above however also applies in the same manner to the comparable uncontrolled price method. In applying a CUP method, an internal comparable would be either the purchase price paid by the taxpayer for comparable goods or services obtained from an unrelated party in comparable circumstances (if the controlled transaction under review is a purchase transaction), or the sales price charged by the taxpayer for comparable goods or services sold to an unrelated party in comparable circumstances (if the controlled transaction under review is a sale transaction).

17. Because of the significance of product similarity when applying the comparable uncontrolled price method, internal comparables have the potential of providing better CUPs than external ones. Again, this has to be evaluated on a case by case basis.

(b) Transactional net margin method

18. With respect to paragraph 3.26 of the Guidelines, some countries point out that in practice where a taxpayer has reliable information on the net margin that the same taxpayer earns in comparable uncontrolled transactions, a resale price or cost plus method could typically be employed at the gross margin level because the taxpayer would have the necessary information. Therefore, given the current hierarchy of methods in the Guidelines, the transactional net margin method is applied by taxpayers and tax administrations mostly using external comparables. This is an issue that is particularly relevant in the context of the OECD’s review of profit methods.

D-2 Internal comparables and particular transactions

19. Internal comparables, where they exist, might be particularly useful in the determination of the arm’s length remuneration for transactions involving intangibles. It is in effect in the area of intangibles that reliable external comparables are the most difficult to find.

20. Internal comparables can also be particularly useful in the area of intra-group services. In particular, where the controlled transaction is the acquisition by a taxpayer of services from a related party, prices paid by the same taxpayer for comparable services obtained from unrelated parties in comparable circumstances can provide a valuable comparable.

D-3 Documentation issue

21. A potential concern with internal comparables as opposed to external ones is that they may potentially result from a less objective selection process. See discussion in separate note on “Selecting or rejecting comparables”. For this reason, it would be reasonable to expect from taxpayers that they clearly indicate:

- Either the reason for not using internal comparables where that is the case (e.g. because they have no internal comparable transactions, or because their uncontrolled transactions were not regarded as valid comparables due to material differences that could not be adjusted),
- Or, in cases where some internal comparables are used, all the relevant information with respect to the comparability factors and the selection process.

D-4 Transactions between other parts of the MNE group and unrelated parties

22. Transactions between another part of the MNE group to which the taxpayer belongs and unrelated parties are not internal comparables under the definition proposed in Section A above. However, these transactions can present some interesting features in common with internal comparables. As internal comparables, they have the potential for a closer relationship to the taxpayer’s transactions (e.g. possibly closer economic circumstances, closer business strategies and greater product similarity) than transactions between two unrelated parties, although this must be approached with great caution as in practice they are often transacted in different circumstances and in different markets. In addition the taxpayer may have better access to information on such transactions than it would have on transactions between two independents. For this reason, this type of transaction should not be overlooked as they can in certain circumstances provide comparables of a better quality than those collected for instance on a database, subject to the five comparability factors being satisfied.

E - Preliminary conclusion

23. It might be worthwhile for the OECD:

In Chapter I of the Guidelines:

- To provide an explicit definition of internal and external comparables,
- To make explicit a general preference for internal comparables over external ones and to encourage practitioners to give proper regard to internal comparables where they exist before doing a search for external ones, while noting that this general preference is not an absolute one but one based on the comparability standard that has to be evaluated in light of the objective to find the best comparable and reliable information,
- To make reference to transactions between other parts of the MNE group and unrelated parties and discuss whether and in what circumstances such transactions could provide more reliable comparables than transactions between two independents.

In Chapters II, III, VI and VII of the Guidelines:

- To clarify some aspects linked to the use of internal comparables when applying specific transfer pricing methods or analysing specific transactions (in particular, transactions on intangibles and services).

In Chapter V of the Guidelines:

To note that taxpayers could reasonably be expected to indicate in their transfer pricing documentation the outcome of their search for internal comparables (e.g. that they do not have reliable internal comparables or that the internal comparables they have identified and used in the transfer pricing analysis reflect a reasonably exhaustive search).

Determination of available sources of information and of their reliability

1. As is acknowledged in paragraph 1.12 of the Guidelines,

“Both tax administrations and taxpayers often have difficulty in obtaining adequate information to apply the arm's length principle. Because the arm's length principle usually requires taxpayers and tax administrations to evaluate uncontrolled transactions and the business activities of independent enterprises, and to compare these with the transactions and activities of associated enterprises, it can demand a substantial amount of data. The information that is accessible may be incomplete and difficult to interpret; other information, if it exists, may be difficult to obtain for reasons of its geographical location or that of the parties from whom it may have to be acquired. In addition, it may not be possible to obtain information from independent enterprises because of confidentiality concerns. In other cases information about an independent enterprise which could be relevant may simply not exist. It should also be recalled at this point that transfer pricing is not an exact science but does require the exercise of judgement on the part of both the tax administration and taxpayer.”

2. Sources of information on potential external comparables can currently be classified under three categories:

A - Informal and confidential information on third parties;

B - Databases that mainly compile accounts filed by companies.

C - Public information such as industry surveys performed by financial analysts and annual reports published by listed companies for regulatory purposes and shareholders' information and information displayed on companies' websites.

In addition, the use of foreign source or non domestic comparables deserves specific comments (D).

Each of these categories is briefly discussed below. Access to information on internal comparables and on internal decision making criteria are not discussed in this note.

3. Regardless of the source of comparable transactions, significant amounts of internal information will always be required in order to be able to perform a reasonable comparability analysis. Additionally, whenever internal comparable transactions with independent parties occur, information from those transactions should be used.

4. Information that is to be used in a comparability analysis also needs to be analysed to determine its basic validity, strengths and weaknesses, and ultimate applicability and impact on the pricing of the transaction. Even information that may not directly relate to the transaction may provide valuable insights into the workings of the transaction with respect to the relative value of functions and attribution of risks between arm's length parties engaged in comparable transactions.

A. Informal and confidential information

A.1 Use of informal and confidential information by a taxpayer

5. Taxpayers may have informal or confidential sources of information. For instance, they may share information at the level of industry groups to which they belong. They may develop market intelligence and acquire some knowledge of their competitors' strategies and performances.

6. Although such information may usefully enlighten business decisions, the use of such data in the context of transfer pricing raises procedural issues in terms of documentation and of burden of proof, when no evidence can be produced because of confidentiality issues. Also, this type of information is by nature non-exhaustive and may introduce additional subjectivity in the analysis.

7. There is general agreement among OECD countries that confidential information obtained by taxpayers would not be appropriate to support their transfer pricing policies. Such confidential information raises a major concern relating to its reliability and auditability. In addition, in some jurisdictions, compilation and use of competitive pricing information obtained outside the public domain may form the predicate for an antitrust or anticompetitive practices investigation.

A.2 Use of informal and confidential information by a tax administration

8. Tax administrations may have access to detailed but confidential information, e.g. from third party tax returns or audits, that is unavailable to the taxpayer. The recourse to confidential information by a tax administration follows from the information asymmetry situation which exists between taxpayers and tax administrations². In particular, some administrations lacking public sources of information might be tempted to use information obtained on other taxpayers through audits or filing procedures. Such information qualifies as "secret comparables" because confidentiality rules would prevent administrations to disclose the identity of these other taxpayers.

a) Comments received from the business community

9. Many business commentators have expressed strong concerns with regard to the use of "secret comparables" which they regard as unfair and lacking transparency. They urge the OECD to specifically reject the use of so-called "secret comparables" as contrary to the obligation on both taxpayers and tax administrations to make a "good faith showing" that the determination of transfer pricing is consistent with the arm's length principle.

2. On the one hand, tax administrators lack much of the internal information (both quantitative and qualitative) available to taxpayers. Although this issue is particularly germane in evaluating internal comparables, it nevertheless affects the ability of tax administrators to most effectively apply the comparability criteria of the Guidelines to available external data and to obtain a full understanding of the relevant facts and circumstances that support the taxpayer's choice of a given transfer pricing method. These issues highlight the importance for a tax administration of relying on sufficient and timely documentation requirements.

On the other hand, tax administrations may have access to better comparable data through use of their access powers. For this reason some tax administrations in conducting a transfer pricing risk assessment have a policy to restrict themselves to assessing the quality of a taxpayer's documentation and look to the commercial realism of the outcomes achieved taking into account the significance of the international dealings with associated enterprises.

This information asymmetry has potential implications in terms of the determination of available sources of information.

10. In fact the issues are twofold as discussed below:

- whether secret comparables can ever be used to legitimise a transfer pricing adjustment where the taxpayer is not in a position to agree or disagree on a secret comparable;
- and whether such secret comparables can validly be used in competent authority procedures.

b) *Use of “secret comparables” in transfer pricing adjustments*

11. OECD countries have contrasting experiences with respect to the use of “secret comparables” in transfer pricing adjustments. On the one hand, most countries recognise that the use of “secret comparables” raise a number of concerns especially with respect to the fairness and transparency of the process (and consequently with respect to the possibility for the taxpayer to appreciate the reliability of such “secret comparables”). On the other hand, given the information asymmetry which exists between taxpayers and tax administrations, some countries do not want to categorically exclude a potential source of valuable information. While business concerns with the use of “secret comparables” are well recognised, a number of revenue administrations continue to have recourse to using this type of information, particularly where publicly available comparable data are limited and where the enterprise is subject to transfer pricing audit, rather than risk assessment.

12. In fact, “secret comparables” raise similar issues as discussed in section A.1 above with respect to the use of confidential information by taxpayers: although some countries consider that such “secret comparables” may provide tax administrations with useful information especially where no better information is available, the use of “secret comparables” raises procedural issues in terms of documentation and of burden of proof, when no evidence can be produced because of confidentiality issues.

13. Some other countries have indicated that, although the use of “secret comparables” in transfer pricing adjustments is theoretically allowed by their domestic legislation, this practice is limited:

- in some countries, by the need to ask consent of the third party concerned before using information related to it,
- in many countries, by the courts which are likely to dismiss such information on the grounds that the taxpayer has not been given enough information to prepare its defence.

14. As far as the obligation of confidentiality/transparency towards the third party is concerned, many country domestic legislations would only allow the use and/or subsequent disclosure of “secret” third party data subject to the full consent of the information source. This may represent a serious practical limitation to the use of “secret comparables”.

i) Fairness

15. Some countries are strongly opposed to the use of “secret comparables” in audits because they consider that it would strike at the integrity of the Transfer Pricing Guidelines and may undermine the process of deriving outcomes that are mutually agreeable to taxpayers and affected revenue authorities.

16. The situation might be different in cases of a taxpayer’s failure to comply with reasonable documentation requirements. Countries where the use of “secret comparables” is allowed by domestic legislation might not wish to rule out a possibility which they see as essential given the existing information asymmetry, as previously discussed - especially those countries where public information is limited. A response might consist in introducing appropriate safeguards to ensure fairness in the process.

ii) Reliability

17. One further concern with the use of “secret comparables” is that it may be inherently less reliable because the taxpayer, who may be best informed concerning the relevant comparability and reliability considerations pertaining to its business, is deprived of any input.

18. In addition, if the selection process is not transparent to the taxpayer, it cannot verify whether or not the process is subjective/objective, reliable/unreliable, therefore whether the result is right or not. Because the identity of the comparable is not disclosed to the taxpayer, the taxpayer cannot evaluate the objectivity/reliability of the selection process from the result.

iii) Conclusion on the use of “secret comparables” in transfer pricing adjustments

19. Ideally the OECD preference is not to use “secret comparables” but it is recognised that in practice some countries do use them, particularly in situations where publicly available comparable information is limited. See also comment in sub-section A.2 (b) (i) above with respect to situations where a taxpayer fails to comply with reasonable documentation requirements. Countries that use “secret comparables” in audits are encouraged to develop appropriate safeguards in their domestic legislation or practices, aiming at ensuring reasonable fairness and reliability for taxpayers.

c) *Use of “secret comparables” in MAP cases*

20. The use of “secret comparables” in competent authority procedures is a possibility that should be clearly distinguished from the use of “secret comparables” in transfer pricing adjustments. In MAP cases, the concern about fairness has to be evaluated in relation to the other competent authority rather than to the taxpayer. As a consequence the question becomes whether in case of MAPs “secret comparables” used by a tax administration can be disclosed to the competent authority of the other State.

21. Some competent authorities might be able to exchange such information, with confidentiality being safeguarded under the applicable bilateral treaty. Subject to the possibility for the other competent authority to verify the validity and completeness of the information, as well as the process by which the information was obtained, it could help resolving double taxation. It would not seem sensible to categorically rule out the possibility to use “secret comparables” in MAPs as they may help resolving disputes. This is an issue which could be examined in the context of the work on improving dispute resolution, as this is more an Article 25 than an Article 9 issue.

B. Databases

22. It is possible to distinguish two types of databases currently available in the market:

B.1 Commercial databases

B.2 Proprietary databases developed by some consulting firms

B.1 Commercial databases

23. Commercial databases have been developed by editors who compile accounts filed by companies with the relevant administrative bodies and present them in an electronic format suitable for searches and statistical analysis. Considering the large number of companies operating in each market and the huge amount of data filed by each of these companies – as well as the shortage of alternative sources of publicly

available information – these electronic databases are currently a frequent way to obtain extensive financial information and sort out comparables on the basis of appropriate selection criteria.

24. Commercial databases either cover a given country or a regional area (e.g. Europe) and MNEs often need to use more than one database, depending on the list of countries in which they operate. Subscriptions to commercial databases can be rather costly, and taxpayers generally do not subscribe themselves to all the databases they need. They rather often rely on an advisory firm that has subscribed to all the necessary databases and has developed the user know-how to perform the search. Current commercial databases can be subscribed to and accessed directly, or embedded in some transfer-pricing software packages which typically contain rudimentary transfer-pricing programming.

25. A number of limitations to commercial databases are frequently identified, in particular the following:

- Because these commercial databases rely on publicly available information, they are not available in all countries. Moreover, where they are available, they do not include the same type of information for all the companies operating in a given country because disclosure and filing requirements may differ depending on the legal form of the company and on whether or not it is listed.
- Care must be exercised with respect to whether and how these databases should be used, given that they are compiled and presented for non-transfer pricing purposes.
- Cost of information is a significant issue, especially for small and medium sized taxpayers, but also for relatively small or less risky transactions. In this respect the usefulness of having recourse to commercial databases – as it is the case for all sources of information – should be tested in accordance with a reasonable evaluation of the facts and circumstances of the case. As indicated in paragraph 5.6 of the 1995 TP Guidelines: “[...] the taxpayer should not be expected to incur disproportionately high costs [...] to engage in an exhaustive search for comparable data from uncontrolled transactions if the taxpayer reasonably believes, having regard to the principles of this Report, either that no comparable data exists or that the cost of locating the comparable data would be disproportionately high relative to the amounts at issue”.
- It is not always the case that commercial databases provide information that is detailed enough to support the chosen transfer pricing method. Not all databases include the same level of detail and can be used with similar comfort. For instance, financial information found in US databases is generally far more detailed than that in European databases, due to for example differences between countries in filing requirements.
- Importantly, it is the experience in many countries that commercial databases are used to compare companies rather than transactions because transactional information is rarely disclosed to the public. One question is whether the quality of these databases could be improved by including more transactional information in countries where the disclosure of such transactional information is not required by law.

26. The OECD Guidelines do not contain any reference to commercial databases. The OECD considers that:

- Commercial databases are one possible source of information among others. Their importance should not be overstated. It is not compulsory for a taxpayer to use a commercial database if reliable information is available from other sources – e.g. internal comparables or market

intelligence developed and maintained for non tax reasons, as well as alternative sources of information. On the other hand, there is no reason to systematically rule out the use of all commercial databases as in some cases they provide the best available information.

- Where commercial databases are used, they should be handled with care and in particular taxpayers or practitioners should make their best efforts to comply with the five comparability factors identified in the 1995 TP Guidelines as well as with the rules on aggregation of transactions. It is expected that commercial databases will be used in an objective manner and that genuine attempts will be made to use the databases to identify the most reliable comparable information.
- Where commercial databases are used, they should not be used alone. The outcome of the search needs to be reviewed, complemented and refined with information from other sources such as websites of selected “comparable” companies, industry journals, etc. For example, commercial databases may be particularly important for identifying potential comparables and recourse to other sources of information, including publicly available financial accounts, may be required to obtain comparable data which can be used in applying the arm’s length principle. Countries have expressed a concern that the use of commercial databases has a tendency to encourage quantity over quality. The requirement to refine the search with other sources of information is meant to promote quality over standardised approaches. This is valid both for database searches made by taxpayers/practitioners and for those made by tax administrations.
- Where one or more database(s) is (are) available, the choice of the database(s) to be used should be made in the context of determining and using the most reliable data available. Obviously, this requirement has to be interpreted in a reasonable way and the objective is not to require a systematic exploitation of all existing sources of information irrespective of the magnitude of the transaction.

27. This means that commercial databases should be used only when they add value to the comparability analysis and that it should not be required in cases where better information can be obtained from other sources. Many countries have a concern that taxpayers and practitioners have a tendency to systematically use databases without first properly reviewing internal comparables and other possible sources of information. Reliability and quality of information are a major concern.

28. The practical experience is that commercial databases are increasingly being used by taxpayers and practitioners in particular (but not only) when using a transactional net margin method. The Working Party might accordingly need to re-visit these issues in the context of the review of profit methods.

B.2 Proprietary databases developed by consulting firms

29. There are also proprietary databases that are developed and maintained by major advisory firms. Such proprietary databases generally raise similar issues as commercial databases that are more broadly commercialised. They also raise a further concern with respect to exhaustivity of data: while commercial databases generally compile all public information in a given area, proprietary databases may be based on client information i.e. on a limited portion of the market.

30. When a taxpayer intends to support its transfer prices with such a proprietary database, the tax administration may request access to the database for obvious transparency reasons. Otherwise, the information derived from the proprietary database may qualify as confidential information and be subject to the restrictions described in section A.1 above with respect to such confidential information.

C. Public information

31. Trade publications on specific industries and industry surveys by financial analysts are very useful to understand the stakes and trends of a given industry sector and to identify potential comparables. In particular, they generally contain comments on business strategies (at least past strategies). However, because their prime focus is on stock value, these surveys generally address the issue of profits on a consolidated basis and do not provide much information on the value of a given function within the consolidated enterprise.

32. Annual reports published by listed companies typically contain useful information on product portfolios and business strategies. In addition, rather detailed business analyses may be published by companies when they get listed on an exchange or when a significant operation on the share capital of a listed company takes place (e.g. share capital increase). These documents however provide comments on consolidated accounts rather than stand-alone entities. Where a group operates in more than one business segment, they generally include some information on each of them, but this is still on a consolidated basis and is not a segregation of functions.

33. Information on stand-alone companies may be found in the statutory accounts filed with administrative bodies in countries where such a filing is required by law. This is not the case in all countries. Where accounts are public information, they could also be obtained (even though generally at higher cost) through commercial databases (see above).

34. Finally, there are also sources of information for specific types of transaction, e.g. commission rates, fund management charges, debt factoring charges, interest rates and guarantee fees that can be useful in finding third party comparables.

35. Publicly available information can be usefully used to complement and improve the quality of a search that is primarily performed on a commercial database. It is also possible to conduct a search that is as exhaustive as possible using public information, without using a commercial database.

D. Foreign source or non domestic comparables

36. In some cases taxpayers might want to use non domestic sources of information, e.g. because they perform a regional search or because, due to the lack of satisfactory domestic comparables, they search information on a non domestic though comparable market (see discussion of non domestic comparables in the note on “Examining the five comparability factors”). One concern with non domestic sources of information is that they might not be verifiable by the tax administration examining the taxpayer. Where non domestic sources of information or non domestic comparables are used in accordance with the principles discussed in the note on “Examining the five comparability factors”, proper access and/or documentation should be given to the tax authorities in charge of the audit to ensure transparency.

37. In considering whether non domestic data should be used the relative significance of market differences (including whether reliable adjustments can be made for material differences) needs to be considered together with the available comparable information in the same market and a judgment made.

Uncontrolled transactions

A- Description of the issue and existing guidance

1. Article 9 of the MTC requires that the conditions made or imposed in commercial or financial relations between two associated enterprises be compared to the conditions which would be made between independent enterprises.

2. An increasing number of business sectors have reached such a level of vertical integration that it is becoming virtually impossible to find truly independent economic actors. For example, it may be the case that in a particular market all distributors in a given business sector are owned by multinational groups.

3. For instance, in many markets the automotive industry is becoming a highly integrated industry and it might be very difficult to identify comparable independent third party distributors. In these markets, most of the multinational players in the automotive industry would follow similar distribution models, i.e. the controlled distributor usually purchases cars from a related party manufacturer and sells them to unrelated car dealers (it is the car dealer that sells the cars to end-users). Assuming the tested party is the controlled distributor, identification of third party uncontrolled transactions that could be potentially compared in practice to the controlled transactions of the distributor can be very difficult.

4. In practice the identification of independent third party comparables is not an easy task and the list of potential external comparables is often very limited. In such instances, third parties that have the most comparable economic environment are likely to be the taxpayer's competitors, even though they may also be organised as multinational enterprises. In the case of the sales subsidiary of an automotive group operating in a highly integrated market, it might be argued from an economic perspective that the most reliable comparison would be found among sales subsidiaries of other automotive groups operating in the same market. Such comparisons should not be utilised as a basis to compute a transfer pricing adjustment (whether by a taxpayer or by a tax administration) because they do not refer to transactions that took place between independent parties: all multinational groups have their own transfer pricing policies and can hardly be regarded as objective points of comparison.

5. Paragraph 1.70 of the Guidelines however states that:

[...]It should not be the case that useful information, such as might be drawn from uncontrolled transactions that are not identical to the controlled transactions, should be dismissed simply because some rigid standard of comparability is not fully met. Similarly, evidence from enterprises engaged in controlled transactions with associated enterprises may be useful in understanding the transaction under review or as a pointer to further investigation [...].

Practical experience

6. In the above automotive industry example, the practitioner may decide to perform an analysis of a panel of sales subsidiaries of automotive groups that have transactions similar to those of the group to which the taxpayer belongs. In practice, experience shows that such surveys are often used by taxpayers (and tax administrations) either in the risk assessment phase or in the transfer pricing analysis, as a reasonableness test or “sanity check”, especially when the transactional net margin method is used as a test in conjunction with another method. The question is to what extent such analysis can be regarded as providing useful information.

7. In other instances it is found in practice that the taxpayer or practitioner cross-checks the results of two sets of data: one set of companies that achieve good comparability of economic circumstances, but that are members of MNEs, and one set of companies that are independent and operate in the same industry, but may be in slightly different economic circumstances because of their stand-alone situation (or one set of independent companies that operate in a different but comparable industry). Taxpayers and practitioners in such cases would argue that if both sets of data have convergent outcomes, they will provide sufficient comfort that the shortcomings of each of the sets, taken separately, are reasonably overcome.

B - Extent to which controlled transactions can be used in a transfer pricing analysis

8. The Working Party discussed these issues and concluded that controlled transactions should by no means be used as the basis for a transfer pricing adjustment. This would be contrary to the wording of Article 9 itself and to the arm’s length principle which require the taxpayer’s commercial or financial relations with its related parties to be compared with commercial or financial relations between independent enterprises. Similarly, information on competitors’ controlled transactions that may be gathered by a taxpayer would generally not be sufficient to support its transfer pricing policy.

9. The OECD recognises that information on controlled transactions may provide valuable indications on an industry sector’s behaviours and trends and might therefore be useful for taxpayers in the risk assessment phase and for tax administrations in the process of identifying taxpayers for examination.

10. It is however worth emphasising that this does not imply any safe harbour type reasoning: the mere fact that a taxpayer’s transactions (or profits) are within the norms of its competitors does not mean that they are within the arm’s length range or that it should not be audited. Similarly, the mere fact that a taxpayer’s transactions (or profits) are outside the norms of its competitors does not mean that they are not at arm’s length.

C - Alternative options

11. The lack of independent transactions in certain markets and industries is one of the major difficulties encountered in comparability analyses, and this difficulty is likely to become even more acute as globalisation is expanding. As pointed out by some business commentators, a growing percentage of the international trade is now between related parties and it becomes increasingly difficult to find transactions between independent parties. There is a need to find a solution to transfer pricing cases even when the industry/market is highly integrated.

12. Section C therefore discusses possible alternatives that can be considered where no satisfactory comparable uncontrolled transaction is found in first analysis, i.e. where a taxpayer has performed a proper comparability analysis and is confronted with the lack of satisfactory independent comparables in a given market/industry.

13. The discussion in this section should not be interpreted as relaxing the comparability requirements: the five comparability factors as well as the aggregation rules would have to be accounted for as usual when applying any of these possible alternatives.

C.1 Broadening the search

14. The Working Party discussed a range of options that might, on a case by case basis, be considered where no satisfactory comparable uncontrolled transactions are found:

1. Use information on uncontrolled transactions taking place in the same industry and comparable geographical market, but performed by third parties that may have different business strategies, business models or other slightly different economic circumstances ; a related question is whether reasonably accurate adjustments can be performed to account for these differences;
2. Use information on uncontrolled transactions taking place in the same industry but in other geographical markets; a related question is whether reasonably accurate adjustments for market differences can be performed;
3. Use information on uncontrolled transactions taking place in the same geographical market but in other industries; a related question is how to select other industries that present sufficient economic similarities e.g. in term of return on investment, life cycles, technologies and whether reasonably accurate adjustments for industry differences be performed.

15. Depending on the facts and circumstances of the case, either of the above options might be acceptable, and it is not desirable to be prescriptive in this respect. In any case, the judgment involved in the choice of given comparables needs to be made explicit (i.e. the reasons why some data are considered to be more reliable than the next best alternative source of potentially comparable information) and the comparability factors and aggregation rules should be satisfied as usual.

C.2 Uncontrolled transactions carried out by MNE groups

16. It might be worth clarifying that rejecting comparisons with controlled transactions does not mean that only information on standalone companies can be used. Subsidiaries belonging to an MNE group may carry out uncontrolled transactions that can potentially be used in a comparability analysis. For illustration purposes, let us take the case of a company that, while belonging to an MNE group, purchases products from third parties at arm's length. Prima facie there is no reason why these uncontrolled purchase transactions could not be used as potentially comparable to a taxpayer's intra-group purchases of similar products.

17. Obviously, in addition to the usual requirements with respect to the five comparability factors and to the aggregation rules, such a comparison with uncontrolled transactions carried out by third party members of MNE groups could only be acceptable if the financial indicia used in the chosen transfer pricing method are not affected by some other controlled transactions³, and if there is no set-off. In

3 If the goods are purchased from third parties at arm's length, the purchase transactions may provide a valid comparable in a CUP. If these goods are re-sold to third parties at arm's length, there may also be a valid

addition, whether such data could provide good “comparables” would depend on whether – and to what extent - the profitability of the subsidiary is influenced by the application of the global MNE strategy.

C.3 Possible use of consolidated data

18. Another suggestion submitted by business commentators concerns the possible use under certain circumstances of group consolidated data i.e. the group as a whole would be regarded as a single enterprise.

19. The Working Party discussed this option and considered that, because such a solution could only apply where the consolidated group carried out a single type of reasonably homogeneous transaction, there would be few cases of application in practice. Some countries are reluctant to accept comparisons with consolidated data and have expressed a concern that in practice such data are often not comparable because of the diversity of functions and risks reflected in the consolidated accounts. However, the Working Party regarded this area as worth exploring and invites business commentators to submit examples of how this could work.

C.4 Influence of minority shareholders

20. An interesting comment received from the business community suggests that where a taxpayer has significant third party shareholders, its controlled transactions might be closer to an arm’s length situation due to the influence exercised by minority shareholders.

21. In fact, the influence of minority shareholders appears to be more relevant to the issue of whether conditions made or imposed in commercial or financial relations affecting the taxpayer differ from the conditions which would be made between independent parties, than to the issue of whether transactions carried out by a third party (which may be partly controlled by minority shareholders) can be regarded as providing valid comparables. The reason is that according to Article 9 of the OECD Model Tax Convention a comparison must be made with uncontrolled transactions (i.e. not with controlled, even though arm’s length, transactions).

22. Another – but related - issue is that there is no detailed definition of “associated enterprise” in the OECD TP Guidelines or Commentary to the Model Tax Convention and each country has a different interpretation of “related party” domestically. As a consequence, the same transaction might be characterised as a “controlled transaction” in one country and as an “uncontrolled transaction” in another country.

23. The Working Party discussed whether the presence of minority shareholders generally leads to the outcomes of a taxpayer’s controlled transactions being closer to arm’s length and concluded that in practice it is not necessarily the case. This is likely to depend on a number of factors, including the following ones:

- Whether the minority shareholder has a participation in the capital of the parent company or in the capital of a subsidiary (minority shareholders in the parent company are likely to be less interested in the arm’s length pricing of intra-group transactions than minority shareholders who have an interest in a subsidiary involved in transactions with the majority shareholder);

comparable transaction for applying a resale price minus method. However, if the goods purchased from third parties at arm’s length are re-sold to related parties, this could no longer be used in the context of a resale price minus method.

- Whether the minority shareholder has and actually exercises some influence on the pricing of intra-group transactions;
- Whether the taxpayer is resident in a tax jurisdiction where there is a requirement to transact at arm's length, or whether it is resident in a jurisdiction where there is (only) a requirement to report an arm's length outcome for tax purposes.

24. While the presence of minority shareholders is one of the elements that may be taken into account in the analysis, it is not sufficient of and by itself to draw a conclusion.

Examining the five comparability factors

Introduction

1. This note concentrates on issues related to the examination of the five comparability factors with respect to external comparables. Most of the discussion in this note similarly applies to internal comparables, although internal comparables, where they exist, are likely to provide a better and easier access to information on comparability factors. When trying to identify external comparables, taxpayers should examine each of the third party transactions which they have identified as potentially comparable, by reference to the comparability standard set forth in the Guidelines, in order to decide whether or not they can be regarded as actually comparable. This comparability standard is to be applied for all the OECD transfer pricing methods, whether traditional or profit methods. It is also noted that availability of reliable comparable data may have a major impact on the transfer pricing method selected. More specifically, five factors determining comparability for all transfer pricing methods are described under paragraphs 1.19 to 1.35 of the Guidelines:

1. Characteristics of property or services
2. Functional analysis
3. Contractual terms
4. Economic circumstances
5. Business strategies

A. General comments on the five comparability factors: evaluating the importance of missing information on the five comparability factors for external comparables

2. Being required in the context of a comparison exercise, the examination of the five comparability factors is by nature twofold, i.e. it comprises an examination of the factors affecting the taxpayer's own transactions and an examination of the factors affecting third parties' transactions.

3. In practice, the level of detail in the information available to a taxpayer on the factors affecting external comparable transactions is very often less than for its own transactions. This difference is currently not properly acknowledged in the Guidelines.

4. Business commentators generally indicated support for the five comparability factors that are regarded as theoretically sound, while unanimously pointing out the difficulty in practice in applying the comparability standard where sufficiently detailed information is not available in the public domain. They favour some flexibility, on a case by case basis, in judging the need to satisfy all five of the comparability factors set out in paragraphs 1.19 to 1.35 of the Guidelines considering that it is rarely if ever possible to identify comparables which meet and can be shown to meet the rightly exacting standards of Chapters 1 and 2 of the Guidelines.

5. The Working Party discussed whether a less detailed analysis of external comparables than of a taxpayer's own transactions would be acceptable because of the practical difficulty involved. It concluded that as a matter of principle a less rigorous analysis of third party transactions would not be acceptable, but that in practice the detail of information needed on each of the five comparability factors affecting the transactions of a third party needs to be assessed on a case by case basis (as in fact is already suggested by the existing language in paragraph 1.18 of the Guidelines).

6. This means that a taxpayer or practitioner performing a comparability analysis should first make his/her best efforts to obtain the best available data on the five comparability factors affecting the third party transactions that are regarded as potentially comparable. This means in particular undertaking an analysis that goes beyond some vague categorization of one of the parties to the controlled transactions followed by the use of lightly-examined comparable companies derived from a public database. In evaluating potentially comparable data, when detailed information on a given factor is not found, the taxpayer or practitioner should exercise judgment to determine the extent to which the missing information is likely to affect the reliability of the comparison. If it can be reasonably assumed that despite some pieces of information being missing, the transactions of the relevant third party are a valid comparable (subject to reliable enough adjustments where needed), the comparison will not be rejected just because of constraints in availability of information. On the other hand, if the missing piece of information is likely to materially affect the comparability, then the transactions of the third party at point will not be regarded as providing a valid comparable. The taxpayer or practitioner may need to find other third party transactions that provide better evidence, if these exist, or to change the transfer pricing method.

7. This approach can be illustrated as follows. Assume the taxpayer's controlled transaction consists in road transportation services of raw material such as concrete, sand etc. Assume six independents providing similar services to unrelated parties in the same geographical area are identified. A review of the five comparability factors is performed and confirms that the services of these six independents are likely to provide valid comparables for the taxpayer's controlled transaction. Assume now that no information can be obtained on the business strategies developed by these third parties, due to confidentiality constraints. The question is the extent to which the missing information is likely to affect the reliability of the comparison. Assume that the review of economic circumstances reveals that this is a very stable industry and that it is found that the six independents are long established local companies that all have broadly similar pricing policies. In such circumstances it might be reasonably assumed that the lack of information on their business strategies is unlikely to materially affect the reliability of the comparison. Assume now that the activity of one of these independents was recently acquired by new shareholders and reorganised, with drastic effects on its cost structure and pricing policy. In such a case, information on the business strategy of this reorganised independent is likely to be of material importance to assess comparability and the outcome of the analysis might be that the transactions of this reorganised independent are not comparable to those of the taxpayer.

8. As indicated in paragraph 1.18 of the Guidelines, "the extent to which each of these factors matters in establishing comparability will depend upon the nature of the controlled transaction and the pricing method adopted" and both parameters must be taken into account when evaluating the relative importance of any missing piece of information. For instance, information on business strategies is likely to be less important if the controlled transaction is the provision of intra-group accounting services than if it is a research and development Cost Contribution Arrangement. Information on product characteristics is more important if the method applied is a comparable uncontrolled price than if it is a transactional net margin method.

B - Discussion of specific issues in relation to each of the five comparability factors

9. When trying to identify third party comparables, third party data will be examined in the light of each of these factors, through a series of qualitative and quantitative criteria. Some of these criteria can be objectively established, for instance those relating to the size of the company or its geographic market where appropriate. Other criteria are more difficult to verify because they concern subjective appreciation of economic situations and/or confidential information on competitors. Each of the comparability factors is discussed below in the context of selecting third party comparables.

10. The extent to which each of these factors matters in establishing comparability will depend upon the nature of the controlled transaction and the pricing method adopted.

B.1 Characteristics of property or services

11. Characteristics of property or services are the first factor determining comparability under the comparability standard set forth in the Guidelines. It is however indicated in the Guidelines that, depending on the method selected, this factor must be given more or less weight. The CUP method is where the requirement for comparability of property or services is the strictest. Under the CUP method, any material difference in products can have an effect on the price and would require an appropriate adjustment to be considered (see in particular paragraph 2.11 of the Guidelines). Under the resale price method and cost plus method, (minor) product differences are less likely to have a material effect on the gross profit margin or mark-up on costs and comparability of property or services is generally less important than under the CUP method (see in particular paragraphs 2.16 and 2.34 of the Guidelines).

12. Product similarity is also less sensitive in the case of the transactional profit methods than it is in the case of traditional transaction methods (see in particular paragraph 3.34 of the Guidelines). This however does not mean that taxpayers can ignore the question of comparability in characteristics of property or services. To some extent it is still important to ensure that the comparison is performed with transactions on similar products or services beside the other comparability factors involved in applying the profit method. The selection of companies acting in the same industry as the taxpayer and known to deal with comparable products can prove to be more difficult than would be expected. The question of whether products and services offered by competitors are comparable to those offered by the taxpayer is often a matter of judgment that can lead to substantial controversy.

13. For illustration purposes, assume that the taxpayer is a sales subsidiary of an MNE group. When looking at potential comparable transactions, it may not be sufficient to select the transactions of other sales companies. To the extent that product differences may impact comparability, it may be that product differences reflect different functions and risks being taken on by the sales companies, different business models employed, or different prices being charged and received. As a result, one may expect to experience difficulty meeting the comparability requirements if trying to apply these potential comparable transactions using a resale minus, profit method, or CUP, respectively.

14. Identifying differences among products that may affect prices is generally an easy process. It is more difficult to identify when differences in products may have an impact on margins. The margin required to perform certain functions and take on certain risks may differ between otherwise seemingly similar products. It is important to remember that product characteristics matter to the extent that they may affect market, functions, assets and risks associated with the transaction involving the product, and how differences in these items may have an impact on arm's length margins. Given the difficulty encountered in identifying when product differences are expected to impact margins, it can be even more difficult to demonstrate that certain product differences may not impact margins. In practice taxpayers often try to overcome these various difficulties by considering mixed products under the assumption that none of the

product differences – or that all of the product differences when taken together – will have a deleterious impact on the comparability of the observed margin. In these attempts, taxpayers rely on the computation of a range of results to indicate, relative to the range, where the arm's length margin for the controlled transaction would be observed. Paragraphs 2.16-2.21 and 3.34-3.40 provide guidance on some of the issues to take into account when establishing the comparability of uncontrolled transactions.

15. In practice, comparability analyses (except when applying a CUP) generally put more emphasis on functions similarities than on product similarities. Broadening the comparability analysis to include transactions that present great similarities in terms of functions but concern different products may be acceptable, but only:

- in the absence of more reliable data (i.e. of internal or external comparables that present a higher degree of comparability including with respect to the characteristics of products). This implies that the taxpayer or practitioner performing the comparability analysis should make reasonable efforts to find more reliable data before deciding to broaden the search; and
- subject to the condition that these product differences do not materially affect the reliability of the comparison, i.e. they do not entail material differences in the way the functions are performed, in the tangible and intangible assets involved, in the risks assumed, and/or in the economic and market circumstances of the transactions. The search should not automatically be broadened to very large categories (e.g. industry codes), but thoughts should be given to what other types of products are likely to offer the closest comparables to the taxpayer's transaction.

16. There is a tendency in a number of comparability studies to consider third parties that manufacture or distribute very broadly defined types of products. Thus, if the controlled transaction relates to the distribution of candles, a search would be made on distributors of "consumer goods" for instance. Even though it is probably true that all consumer goods present a number of similar economic characteristics, it is not the case that they all earn the same level of gross or net margin. In addition they may be subject to different life cycles, and suffer or benefit from external effects provided by a sector of activities they are related to.

17. A mere similarity of functions between two enterprises does not necessarily lead to reliable comparisons; the other comparability factors should also be given attention. One of these factors is the characteristics of products. Assuming a third party performs similar functions as those of the taxpayer, it might still not provide for a valid source of comparable transactions if the enterprises concerned carry on those functions in different economic sectors or markets with different levels of profitability or where the observed data includes the results of the third party's execution of additional functions. There will be cases where product differences do not materially affect the application of the transfer pricing method because they do not entail any significant difference in the transaction performed, e.g. where this transaction is a routine function that is performed in a similar manner for a variety of products, requiring the use of similar assets and the assumption of similar risks. In such a case independent parties which deal with products different to the taxpayer's should not be discarded only because of minor product differences. On the other hand, some industries have special requirements that necessitate specific equipment, process or know-how (e.g. for fresh food products, dangerous chemicals or sterile products) i.e. the tangible and intangible assets used in a particular transaction may be significantly affected by the nature of the product. Looking at sales functions, selling activities of different products are likely to be largely comparable. However, it would be simplistic to argue that product differences never matter for a distributor and that, for example, a distributor of ethical drugs can be compared with a distributor of bananas, because they employ staffs with significantly different skills, require different physical assets and intangibles, and are subject to different market fluctuations, i.e. product differences entail significant differences in the functional analysis of these

distributors. Again, the decision whether to regard a third party transaction as comparable should be made in the context of determining and using the most reliable comparable data available.

B.2 Functional analysis

18. Comparability of functions performed, risks assumed and assets used is one essential factor to any comparability analysis, whatever the method used. Comments in this respect can be found in particular in paragraph 2.9 of the Guidelines for the CUP method, paragraphs 2.21 to 2.25 for the resale price method and paragraphs 2.34 and 2.39 with respect to the cost plus method. In the context of transactional profit methods, similarity between functions performed is generally considered even more important than similarity of products or services. The major expected result of a functional analysis is to ascertain which are the most economically important functions, assets and risks and how these might be reflected in terms of an arm's length price, margin or profit. The importance of the functional analysis is increased in practice when a comparability analysis essentially relies on similarity of functions, as discussed in sub-section B.1 above.

19. The functional analysis of a taxpayer's own transactions does not raise any particular issue with respect to availability and reliability of information. Sometimes it may be valuable to consider a global functional analysis, if such an analysis exists, to better understand the functions, assets and risks of the tested party. It might be worth re-emphasising that the functional analysis of the taxpayer itself is one of the foundations of the comparability analysis that should not be reduced to a few ticks in a pre-formatted table. The objective of performing a functional analysis of the taxpayer's transactions is to identify the conditions of said transactions that need to be taken into account for any comparability analysis and transfer pricing assessment to be meaningful. Experience is that where the functional analysis undertaken in the taxpayer's documentation proves to be inadequate, this has a direct effect on the standard of the comparability analysis.

20. As far as the functional analysis of third parties' transactions is concerned, however, experience shows that the selection of third parties performing comparable functions, using comparable assets and assuming comparable risks often lacks accuracy, because detailed information on third parties is very difficult to obtain as discussed below. In practice it is found that some taxpayers or practitioners have a tendency to consider that this relative lack of accuracy of the functional analysis of third parties might be counterbalanced by the size of the sample of third party data, i.e. as long as most of the companies of the sample are broadly functionally comparable, the outcome would still be meaningful. The Working Party however is strongly of the view that quantity does not make up for poor quality of data.

Example

21. TAXPAYER is a subsidiary of an MNE that designs, manufactures and sells electronic equipment. TAXPAYER is performing sales and distribution functions. It purchases finished goods from a related party manufacturer at a price that is determined according to the transactional net margin method. In order to ascertain the appropriate net margin level, TAXPAYER has identified a list of independent third parties that are distributing electronic equipment. It is however not always possible for TAXPAYER to obtain accurate information on a number of circumstances, for instance:

- Have these third parties financed or co-financed R&D programs related to products they sell.
- What is the level of involvement and the autonomy these third parties have in the definition of advertising campaigns and in the communication strategy for the products they distribute on their market. Are they provided with marketing material from the suppliers and if this is the case at what financial conditions. Do suppliers provide them with training programs for their sales force.

- Do these third parties offer warranty extensions to their customers in addition to the legal warranty provided by the manufacturers.
- Etc.

22. Under the 1995 TP Guidelines, a comparison of functions also requires an analysis of assets used and risks assumed by the potential comparables. This is often not possible to ascertain as relevant information on assets used and risks assumed may not be available at all or even where such information can be obtained indirectly, e.g. by examining the associated expenses, it still may not be comparable because of differences in the way the information is presented in the accounts. The types of information about potential comparables that could be relevant includes:

- What assets (both tangible and intangible assets) are used by third party distributors.
- Do the third party distributors assume the costs/risks of obsolete inventories or do the manufacturers finance these costs.
- Do they bear foreign exchange exposure and if this is the case to what extent.
- What are the payment terms agreed upon with their suppliers and customers.
- Etc.

23. While relevant to the functional analysis, this type of information often is not publicly available, or can be difficult and costly to obtain. In practice, it is observed that comparability studies often rely on similarity of broad functions (e.g. manufacturing or sale) refined using any information that may be available on the potentially comparable third parties – but which is not exhaustive and is difficult to document. Whether the outcome of such a study is reliable enough and provides the best available comparables depends on the circumstances of the case, likely significance of the missing information, and quality of the available information. See also discussion in separate note on “Determination of available sources of information and of their reliability”.

B.3 Contractual terms

24. As mentioned in paragraph 1.17 of the Guidelines, contractual terms are one of the important attributes to examine in order to establish the degree of actual comparability, because they may affect conditions in arm’s length dealings. Contractual terms are particularly important in determining the allocation of risks among the parties, but also to payment terms, delivery conditions, commitments to purchase given quantities, etc. Comparability of contractual terms is however quite rarely used as a selection criterion, because information on contractual terms negotiated by third parties is usually not available – and can hardly be disclosed if and when available. It is also very difficult to compute reliable adjustments to account for differences in contractual terms although they may have significant impact on profitability. For instance, an exclusivity clause in a licence agreement may be an important characteristic of the activity performed by the licensee, but its impact on the gross or net margin earned by the compared entities is very difficult to value.

25. Contractual terms may in fact be more important in relation to determining how unrelated parties act. When contractual terms in controlled transactions differ from those conditions made or imposed between unrelated parties, this might be a reason to examine the economic logic of the structure. It might also be useful to consider whether the purported allocation of risks is consistent with the economic substance of the transaction (see paragraph 1.26 of the Guidelines). The impact on the price of the contract should be determined. Further, the specific contractual terms may be assumed to have an impact on price

when between unrelated parties the term would not be included or would be a necessary condition to the contract. For example, a related party license agreement may give non-exclusive rights within a territory. Exclusivity may or may not be a factor that would impact the price paid for goods purchased for resale under the license, or a factor in whether or how much royalty may need to be paid for the license. The fact of whether the license is effectively exclusive may also be an important factor to include in the analysis. In short, the fact that a term is included in a related party contract that is assumed to have value does not mean it would have value in the specific transaction under review.

26. Contractual terms can also raise the issue of recognition of the transaction as legally structured by the taxpayer. The Guidelines discuss the issue of recognition of transactions at paragraphs 1.36 to 1.41. The terminology in the Guidelines discusses that tax administrations should recognise the “actual” transactions undertaken by the taxpayer, by which they mean in accordance with the legal structure established by the taxpayer. Where the legal structure does not match the economic substance, or where arm’s length parties would not undertake the transaction as structured, it may be necessary to re-characterise the transaction to reflect the economic substance or to adjust the conditions. Some further work on the idea of recognition of transactions and purported allocation of risk will be undertaken in the context of the project on Business Restructuring.

27. The extent to which contractual terms matter in establishing comparability will depend upon the nature of the controlled transaction and the pricing method adopted (see paragraph 1.18 of the Guidelines). For instance, if the controlled transaction is a license agreement and the transfer pricing method the comparable uncontrolled transaction method, information on the key contractual terms (duration, geographic area, exclusivity, etc) can be assumed critical to assess the reliability of the comparison. On the other hand, if the controlled transaction is the provision of accounting services and the comparison made with the price of similar services offered by accounting firms, details on contractual terms such as payment terms are unlikely to be of great significance.

B.4 Economic circumstances

28. The question arises as to how to determine if economic circumstances are indeed comparable. In practice, both quantitative and qualitative criteria can be used to include or reject third party transactions depending on whether or not they are carried out under comparable economic circumstances. The most common quantitative criteria are:

- Size criteria in terms of Sales, Assets or Number of Employees: they are used to test whether or not companies, due to their size, are in significantly different economic situations;
- Intangible-related criteria such as Net Value of Intangibles/Total Net Assets Value, or ratio of R&D/Sales where available: they make it possible for instance to exclude companies with significant intangibles or R&D activities when the tested party is a contract manufacturer which does not own significant manufacturing intangible nor participate in R&D;
- Criteria related to the importance of export sales (Foreign sales/total sales), when relevant;
- Criteria related to inventories in absolute or relative value: they can be used, for instance, to specifically search for manufacturers with no inventories when the taxpayer is a toll manufacturer that does not take title of inventories.

29. Other criteria may be used to exclude third parties that are in peculiar situations such as start-up companies, bankrupted companies, etc. when such peculiar situations are obviously not appropriate

comparisons⁴. Any quantitative criteria should be developed and used with some caution. Judgment may be needed in determining whether potential comparables should be accepted or rejected, rather than solely relying on the application of quantitative criteria.

30. The existence of a cycle (economic/business/product cycle) affecting a taxpayer's transaction (or third party potential comparables) is one of the economic circumstances that may need to be examined in order to assess comparability between a taxpayer's controlled transaction and third party transactions. In this respect, it would not be sufficient to claim there is a cycle in order to dismiss third party comparable information. Where a cycle is involved taxpayers should make an effort to explain why they believe there is a cycle, what type of cycle it is (business cycle, product cycle...), what the duration of the cycle is, where the controlled enterprise is situated in that cycle and in what way and to what extent the cycle is expected to impact on the data to be used in different types of transfer pricing methods (i.e. price, margin, function, risk etc.). The same would apply where it is a third party, used as a comparable, which is said to be under the influence of a cycle.

31. Again, the significance of differences in economic circumstances needs to be carefully considered. For example, due to the myriad of factors likely to affect performance of an independent entity, it may not always be possible to quantify the economic impact of observed differences to factors such as differences in size (measured by turnover, number of employees etc.) or in the relative competitive position of the buyers and sellers (see paragraph 1.30 of the TP Guidelines). The size of the transaction in proportion to the activities of the third party might affect the relative competitive positions of the buyer and seller and therefore comparability. Judgment needs to be applied when considering these factors also when evaluating the relative significance of, for example, differences in size compared with product differences.

32. There are also a number of qualitative criteria that can be considered depending on the facts and circumstances of the situation under examination. Among the most important is the choice of the relevant geographic market.

Comparable geographic market

33. The geographic market is one of the major economic circumstances that must be examined in the light of the comparability standard. Taxpayers do not always perform comparability studies on a country-by-country basis. There are two main reasons for taxpayers to rather perform wide regional analyses. First, wide regional analyses may be used when searches performed at domestic level do not provide enough or any comparables. In particular, taxpayers operating in small countries often face great difficulties in identifying comparables acting on the same domestic market. Structural changes may also restrict the availability of comparables in a domestic market, e.g. the growth of large scale retailers dealing directly with manufacturers and thereby reducing or eliminating the need for distributor/marketers. Moreover, notwithstanding the size of the market, there are countries where no or very limited third party data are publicly available for legal reasons. Secondly, regional analyses allow taxpayers to significantly reduce compliance costs (e.g. performing a single European wide analysis is far less costly than performing as many analyses as countries of operation in Europe).

34. The use of non domestic transactions in a comparability analysis raises a number of issues. The first one is of course whether the domestic and foreign markets are actually comparable. Geographical proximity is not sufficient to establish comparability as markets situated in the same region might in some cases be very different.

4. Where a company has been subject to criminal convictions and the proceedings revealed that company information was unreliable, there are also issues in relation to the validity for the purposes of the comparability analysis of information relating to that company.

35. Another difficult issue with the use of non domestic comparables relates to the differences in accounting standards (although the issue of accounting standards is not limited to the use of non domestic comparables and has wider implications). Even where markets are economically comparable, information gathered on third party transactions might not be comparable if calculated according to significantly different accounting standards – as it is not always possible to make reliable adjustments for differences in accounting rules.

36. Tax administrations are also confronted with issues in relation to the auditability of comparability analyses submitted by taxpayers. Where a taxpayer uses foreign comparables, domestic tax authorities may not have proper access to the necessary information on said foreign comparables. See comments in separate note on “Determination of available sources of information and of their reliability”.

37. In order for non domestic comparables to be acceptable, it is necessary that they satisfy the comparability factors – in particular in terms of comparability of geographical markets and accounting standards – and that information provided is verifiable. Where this is the case, tax authorities should not automatically reject the use of non-domestic comparables just because they are not domestic. There are circumstances where non domestic comparables can be acceptable.

38. The identification of the relevant market is a factual question. For a number of industries, large regional markets (e.g. Asia/Pacific, USA/Canada, South and Central America, Europe) may prove to be homogeneous and it may be the case that the relevant geographical market encompasses more than one country, while for others, differences among domestic markets (or even within domestic markets) are huge. Adjustments may in certain cases be performed to account for certain market specifics (interest rate, price of land, standard of living, etc.). This is a fact-specific matter and should be appreciated on a case by case basis.

39. In an increasing number of cases an MNE group in effect approaches a group of several countries as a single homogeneous market, where it delivers the same or similar products or services, performs similar functions, using similar assets and assuming similar risks, establishes similar contractual terms, and develops a single business strategy and market policy (in particular in terms of supply sources and of third party customers’ pricing). In cases where a homogeneous market spanning several countries has been factually identified, it may be appropriate for this MNE group to rely on a multiple-country comparability analysis to support its transfer pricing policy towards this group of countries. But there are also a large number of situations where an MNE group offers significantly different ranges of products or services in each country; and/or performs significantly different functions in each of these countries, using significantly different assets and assuming significantly different risks; and/or where its business strategies or economic circumstances are found to be significantly different; in these latter situations, the recourse to a multiple country approach is likely to lead to inappropriate results.

40. The potential impact of geographic market differences needs to be considered relative to the impact of the other comparability factors. While non domestic comparables might be acceptable where they satisfy the comparability requirements, this should not be interpreted as permitting the systematic use of regional searches for comparables for all the subsidiaries of a MNE group operating in a given region of the world, without proper regard being given to the particular circumstances in which each of these subsidiaries operates.

B.5 Business strategies

41. Business strategies may impact the application of the OECD transfer pricing methods and information on strategies conducted by third party comparables are in theory needed to ascertain the reliability of the comparison. Details on business strategies however are rarely in the public domain, even

though a taxpayer may obtain broad pieces of information on third parties, especially in the annual reports filed by some companies, or when a third party is in a market penetration phase. Although listed companies often disclose some information on their strategies in their annual reports, it is very difficult for taxpayers to be sure they have adequately accounted for all differences in business strategies of third parties compared.

42. As already indicated and in accordance with paragraph 1.18 of the Guidelines, the extent to which knowledge of third parties' business strategies matters in establishing comparability will depend upon the nature of the controlled transaction and the pricing method adopted.

43. Concerning market penetration strategies, the experience of Member countries is that such strategies between unrelated parties are typically marginal transactions and when such strategies are claimed between related parties they tend to differ significantly from those between unrelated parties, including in respect of the duration of the strategy. Therefore, they should be used with caution.

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

A- Description of a typical process for identifying comparable transactions and using data so obtained

1. Searching information on comparable transactions generally⁵ requires a number of steps to be completed in a logical order. Typically, this sequential order may be described as follows:

- Step 1: Broad based analysis (e.g. industry analysis, analysis of value-drivers, nature of the competition experienced and economic and regulatory factors).
- Step 2 : Determination of years to be covered.
- Step 3 : Review of the controlled transaction(s) under examination, in order to identify the relevant factors that will influence both the choice of the appropriate method(s) and the comparability analysis, in particular the scope, type, value and timing of the controlled transaction(s), as well as information on the five comparability factors (characteristics of property or services, functional analysis, contractual terms, economic circumstances and business strategies).
- Step 4 : Review of existing internal comparables. Where necessary (i.e. where satisfactory internal comparables are not available), decision to look for external comparables.
- Step 5: Determination of available sources of information on external comparables where such external comparables are needed (including but not limited to commercial databases) and of their reliability.
- Step 6: Choice of the relevant transfer pricing method(s) and, depending on the method(s), definition of the relevant indicia (e.g. definition of the relevant net profit indicator in case of a TNMM).
- Step 7: Identification of potential comparables: defining the key characteristics to be met by any uncontrolled transaction in order to be regarded as potentially comparable, based on the relevant factors identified in Step 3 and in accordance with the comparability standards set forth in paragraphs 1.19 to 1.35 of the Guidelines (i.e. functional analysis, economic circumstances, etc.).

5 In particular when applying a cost plus, resale price minus or transactional net margin method. Search for comparables when applying a profit split method, or for particular transactions such as CCAs might follow a different process.

- Step 8: Determination of and making comparability adjustments where appropriate.
- Step 9: Interpretation and use of data collected, determination of the arm's length remuneration.
- Step 10: Implement support processes. Install review process to ensure adjustment for material changes and document these processes

2. The above sequential order is only illustrative. In practice, the process is not a linear one. Steps 5 to 7 in particular might need to be carried out repeatedly until a satisfactory conclusion is reached, especially because the examination of available sources of information may in some instances influence the choice of the transfer pricing method. For instance, in cases where it is not possible to find information on comparable transactions (Step 7) and/ or to make reasonably accurate adjustments (Step 8), taxpayers might have to select another transfer pricing method and repeat the process starting from Step 4. Let us take the example of a controlled transaction that is analysed as a sale of branded products by a fully-fledged manufacturer to a low risk distributor (Step 3). In this example, it is assumed that the CUP method is initially selected as the preferred method (Step 4) but a reliable enough comparison cannot be made at the level of these direct indicia, e.g. due to the inability to adjust for product differences or the brand name (Step 6). The taxpayer may then select a resale price method (Step 4 again) consistent with the outcome of functional analysis of the controlled transaction that was performed in Step 3. He would then again try to identify comparables (steps 4 to 6), now focusing on comparable gross profit margins earned by comparable distributors in comparable circumstances. If the outcome of the analysis in Step 3 was that the controlled transaction at hand is a sale by a low risk manufacturer to a full-fledged distributor, the method selected might be a cost plus method and the taxpayer would be looking for comparable manufacturers rather than distributors.

3. It is worth emphasising the necessary link between the various steps of the search for comparables and the comparability analysis. This issue is further discussed in a separate note "Putting a comparability analysis in context".

B - Degree of objectivity of the list of comparables: the "additive" and the "deductive" approaches

4. It might be worthwhile for the OECD to develop further guidance on the process to be followed to identify potential comparables (i.e. step 7 of the typical process described in paragraph 1 above). This step is one of the most critical - it requires the exercise of judgment and is potentially a very subjective exercise, hence the need to ensure some degree of objectivity and transparency.

5. There are basically two ways in which the identification of potentially comparable third parties transactions can be conducted. The first one, that can be qualified as the "additive" approach, consists in the taxpayer drawing up a list of third parties that he believes carry out potentially comparable transactions. The taxpayer then collects as much information as possible on transactions conducted by these third parties to confirm whether they are in effect acceptable comparables, based on the pre-determined comparability criteria. This approach arguably gives well-focused results – all the transactions retained in the analysis are carried out by well-known players in the taxpayer's market⁶. It might however suffer from lack of

6 Contrary to certain "comparable studies" that would include a large number of third parties that are totally unknown in the taxpayer's market but are classified under the same activity code as the taxpayer in a database.

objectivity especially because it does not offer a full picture of a taxpayer's industry and therefore might potentially permit "cherry-picking" of the most favourable external comparables.

6. The second possibility, the "deductive" approach, starts with a wide set of companies that operate in the same sector of activity, perform similar broad functions and do not present economic characteristics that are obviously different. The list is then refined using publicly available information (databases, internet sites, taxpayer's knowledge of its competitors) and, in particular, using qualitative criteria such as those relating to product portfolios and business strategies.

7. In practice, the "deductive" approach typically starts with a search on a database. It is therefore important to note that this approach – as any approach – should not be implemented without proper regard being given to internal comparables (step 4 of the typical process described above). In addition, the "deductive" approach is not appropriate to all cases and all methods (e.g. it is not appropriate for the CUP method) and the discussion in this section should not be interpreted as affecting the hierarchy of methods set out in the current OECD Guidelines.

8. When a "deductive" approach is used in appropriate circumstances, it is very important that the taxpayer justify and document the criteria used to include or exclude particular third party data in order to ensure a reasonable degree of objectivity and transparency, i.e. in particular the process should be reproducible by a tax administration that wishes to assess it. It is also very important that third party data be refined using qualitative criteria. It would be improper to use financial information relating to the transactions of a large sample of companies that have been selected solely because they are classified under the same activity code and satisfy some quantitative criteria, although their transactions would not in effect be comparable to those of the taxpayer.

9. One perceived advantage with the "deductive" approach is that where it is followed in a proper way, the acceptability of the outcome might be easier to ascertain than with the additive approach because the review of the comparability study would concentrate on the relevance of the selection criteria retained, i.e. the "deductive" approach is generally capable of providing better transparency, objectivity and reproducibility than the "additive" approach. On the other hand, it is acknowledged that the quality of the outcome of a "deductive" approach depends on the quality of the search tools on which it relies (e.g. quality of the database where a database is used and possibility to obtain detailed enough information). This can be a practical limitation in some countries where the reliability and usefulness of databases in comparability analyses is questionable.

10. The Working Party considers that it would not be appropriate to give systematic preference to one approach over the other one because, depending on the circumstances of the case, there could be value in either the additive or the "deductive" approach, or in a combination of both. The objective should always be to try to find the best available data.

11. The "additive" approach may be used as the sole approach where a taxpayer has knowledge of a few third parties that are engaged in very similar transactions. It is worth noting that the "additive" approach presents similarities with the approach followed by a taxpayer when identifying internal comparables. In practice, an "additive" approach may encompass both internal and external comparables.

12. Moreover, the "additive" and "deductive" approaches are often not used exclusively. In a typical "deductive" approach, in addition to searching public databases it is common to add lists of third parties that would not otherwise be identified from a simple database search prior to analysing and selecting comparables. For example, if a database is being searched for automotive engines then a list of companies building marine engines may be added to allow those companies to be considered for reliability as comparables.

13. Taxpayers generally expect to find known competitors (or third parties which are known to carry out transactions potentially comparable to those of the taxpayer) in the set of comparable data extracted from a database, but it is often the case that some of the known competitors/third parties are not found e.g. because they are classified under a different industry code. Financial data of known competitors/third parties is then added to the population of potential comparables manually. This however is a subjective process and it would be preferable that this step be achieved by reconsideration of the search steps, i.e. a new search would be performed that includes not only the known competitors/third parties⁷, but also other third parties that were not identified initially but are found to fulfil the same criteria as the known competitors/third parties according to the database. In such cases, the “additive” approach operates as a tool to improve the quality of the “deductive” approach.

C - Transparency and reproducibility of the process followed to select or reject comparables

14. The quality of a comparability analysis can only be assessed if it is reproducible i.e. in particular:

- the process followed and criteria used to select or reject comparables (step 7 of the typical process described in paragraph 1 above) is clearly documented,
- and the person reviewing it (taxpayer or tax administration) can have access to the same sources of information.

Concerning access to information, see comments on the use of confidential information and secret comparables and on proprietary databases developed by consulting firms, in separate note on “Sources of information”.

15. The choice of qualitative and quantitative criteria has a significant influence on the outcome of the analysis performed and should reflect the most meaningful economic characteristics of the transactions compared. There is an obvious matter of judgment in the choice of selection criteria and in particular in the definition of the values applied to quantitative criteria.

16. As expressed by one business commentator in response to the comparability questionnaire, because every enterprise is unique, complete elimination of subjective judgments from the selection of comparables would not be feasible. However, much can be done to increase objectivity and ensure transparency in the application of subjective judgments. Taxpayers (and tax administrations) should properly identify the criteria, both quantitative and qualitative, used to select potential comparables, provide the rationale for the use of such criteria and the reasons for excluding some of the potential comparables.

17. Concerning the need to document the process followed, see comments in separate note on “Documenting the comparability analysis”.

⁷ Subject, of course, to their fulfilling the comparability factors, in particular with respect to access to transactional information and independent transactions

Determination of and making comparability adjustments where appropriate

A - Existing guidance

1. The need to adjust comparables and the requirement for accuracy and reliability are pointed out in the Guidelines in several occasions, both for the general application of the arm's length principle and more specifically in the context of each method. Paragraph 1.15 states that:

“[...] 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* [emphasis added] adjustments can be made to eliminate the effect of any such differences. [...]”

2. Further comments on adjustments in the context of the CUP method, the resale price method and the cost plus method can be found respectively in paragraphs 2.7 to 2.9 of the Guidelines, paragraph 2.16 and paragraph 2.34. Examples in the context of the CUP method are developed in Paragraphs 2.10 to 2.13 whereby adjustments are needed with respect to differences in branded versus unbranded products, differences in transportation terms or differences in volumes. Concerning the resale price method, the Guidelines provide several examples in paragraphs 2.29 to 2.31 for instance where one distributor offers a warranty while the other does not. Examples in the context of the cost plus method are found in paragraphs 2.46 to 2.48 of the Guidelines.

3. When considering the transactional net margin method, paragraph 3.2 of the Guidelines states:

“[...] the reliability of a method should be assessed taking into account the principles discussed in this Report, including *the extent and the reliability* [emphasis added] of adjustments to the data used.”

4. Paragraph 3.39 of the Guidelines in the context of the transactional net margin method indicates:

“[...] where differences in the characteristics of the enterprises being compared have a material effect on the net margins being used, it would not be appropriate to apply the transactional net margin method without making adjustments for such differences. The *extent and reliability* [emphasis added] of those adjustments will affect the relative reliability of the analysis under the transactional net margin method.”

5. The discussion in this note concentrates on comparability adjustments in the context of a cost plus, resale price or transactional net margin method.

B - Practical experience in adjusting comparables

6. The existing guidance is limited in the Guidelines on how to handle comparability adjustments in practice. Some countries have extensive experience of adjustments while some others do not. Experience with comparability adjustments shows that there are many types of possible adjustments, some of them

being specific to a given transfer pricing method. In practice adjustments are in some cases applied to the third party comparables, in other cases to the controlled transaction.

7. Comparability adjustments can be divided into three broad categories as noted in Sections B-1, B-2 and B-3 below.

B -1 Accounting adjustments

8. Taxpayers are facing practical issues with respect to comparability analysis where accounting standards of the compared enterprises are potentially different. In this respect, paragraphs 2.37 and 2.38 of the Guidelines relating to the cost plus method indicate that:

“[...]when applying the cost plus method one should pay attention to apply a comparable mark up to a comparable cost basis.

[...] it is particularly important to consider differences in the level and types of expenses -- operating expenses and non-operating expenses including financial expenditure[...].”

9. Paragraph 3.40 of the Guidelines related to the TNMM states that:

“Another important aspect of comparability is measurement consistency. The net margins must be measured consistently between the associated enterprise and the independent enterprise. In addition, there may be differences in the treatment across enterprises of operating expenses and non-operating expenses affecting the net margins such as depreciation and reserves or provisions that would need to be accounted for in order to achieve reliable comparability.”

10. There are various types of differences in accounting standards and practices. Some are permanent differences, while others are timing differences that reverse over time and are generally adequately overcome by using multiple year data, or when the period under examination is long enough.

11. There are classification differences, i.e. whereby certain operations are recorded in different accounting lines. For instance, commercial rebates granted to customers may be recorded as negative sales or as marketing expenses depending on the standards applied, thus resulting in discrepancies in the analysis of gross margins. Another example pertaining to the resale price method is where the cost of R&D may be reflected, depending on the accounting standards applied, either in the operating expenses or in the costs of sales, thus making the gross margins not comparable unless appropriate adjustments can be made (see paragraph 2.28 of the Guidelines). Similarly, when using the cost plus method, differences across enterprises in the treatment of their costs may affect the mark-up on costs (see paragraphs 2.37 and 2.38 of the Guidelines). In particular, there is not a clear distinction of indirect costs and operating expenses.

12. Many of these differences are eliminated when the analysis is performed at a net margin level. This is why the identification of differences in accounting standards may in certain cases encourage taxpayers to select a transactional profit method (TNMM or a profit split at net profit level). Other differences can affect net margins in the same way as they affect gross margins. These are for instance differences in depreciation periods (although a timing difference, this may induce significant distortions, especially for manufacturing activities); treatment of employees' stock options, etc.

13. Differences may also arise from elective rules, for instance when companies have the choice to capitalise or expense R&D costs. Thus, a company may have developed significant intangibles and hence record no intangible property in its assets. Similarly, rules applicable to goodwill recognition and amortisation can create significant discrepancies among companies' accounts.

14. In many cases, it is almost impossible for a taxpayer to identify all differences in accounting standards and accordingly adjust third party accounts on the basis of publicly available information. The issue is more critical when the analysis covers more than one country. This is an obvious weakness in many comparability analyses.

15. Potential inconsistencies in reporting of company financial data by private reporting services and inconsistencies among methods of reporting among individual companies can however be identified and to a large extent resolved by close evaluation of the company's original data and the principles used by the reporting firm. This level of secondary investigation is necessary before such data may be relied upon to evaluate arm's length pricing and should generally be performed after the final selection of comparables.

16. The changes and convergence in accounting standards may have a positive effect on comparability because the results of many MNEs will be reported on a consistent basis – although it is not clear how this will affect comparability of unrelated transactions performed by independent companies (i.e. companies that are not member of a MNE group). Some business commentators advocate for further work to be done in this area.

B -2 Balance sheet or asset intensity adjustments

17. The most common adjustments applied by taxpayers, especially when using a transactional net margin method, are balance-sheet or asset intensity adjustments, designed to account for different levels of inventories, receivables, payables, interest rate, etc. Asset intensity or balance sheet adjustments are intended to account for the fact that the amount of capital used in a business affects its economic profit.

18. Adjustments to reflect differing levels of accounts receivable, accounts payable and inventory (“working capital adjustments”) between the taxpayer and potential comparables are found in transfer pricing documentation presented by taxpayers. These types of adjustments are also made by some tax administrations when performing transfer pricing adjustments. Working capital adjustments are also described as most common by several business commentators. Although working capital adjustments may be the most common balance sheet adjustment, other types of balance sheet adjustments might in some cases improve comparability between the controlled and uncontrolled taxpayers.

19. The fact that such adjustments are found in practice does not mean that they should be performed on a routine or mandatory basis. Rather, the improvement to comparability should be shown when proposing these types of adjustment (as for any type of adjustment). Further, a significantly different level of relative working capital between the controlled and uncontrolled parties may result in further investigation of comparability characteristics of the potential comparable, or may reflect working capital terms or practices (e.g accounts receivable terms or practices) that lack economic substance. In such cases, merely making a working capital adjustment would not alleviate what are in fact more fundamental problems.

20. An example of a working capital adjustment is provided in the Annex to this note.

B - 3 Other adjustments

21. Some countries experience adjustments proposed by taxpayers or tax administrations to account for certain specific economic circumstances that are believed to affect the transactions being compared. Such adjustments can prove to be rather sophisticated and sometimes include an analysis of possible correlations among various economic factors. Countries have different experiences in this respect.

22. Examples of such adjustments include:

- Adjustments for equipment failure, inefficiency or investment in new plant and equipment that needs time to become fully operational where such significant factors are claimed to have affected the taxpayer's controlled transactions. There is currently no guidance in the Guidelines on whether and in what cases such adjustments can/should be performed. In practice their reliability may be questionable in particular when it is not possible to determine whether (and if so to what extent) the selected third party comparables may have been affected similarly;
- Adjustments to account for different contractual terms, although the determination of reliable enough adjustments in this respect is a difficult task as discussed in the note on "Examining the five comparability factors";
- Adjustments for geographical/market differences especially when non domestic comparables are used, although there is no clear guidance on whether and how such adjustments can be performed in a reliable enough manner.

23. It is not possible nor desirable to make a list of all possible comparability adjustments. It is always possible to design new and sometimes unusual adjustments to any set of proposed "comparables". The question is not so much whether a proposed adjustment is "classical" or "unusual" as whether it reliably improves the comparability of the adjusted data. This question is further discussed in Section C below.

24. Adjusting data related to third party transactions where the functions performed or risks assumed differ from those in the taxpayers' controlled transactions does not necessarily provide improvement of comparability. Differences in functions and risks may not be per se eliminated in this way. For example, if a search for contract manufacturing transactions results in a set of comparables that appear to be transactions performed by fully fledged manufacturers, this set may not be improved simply by making an adjustment for inventories level. Even after such an adjustment, the transactions of a full fledged manufacturer may not be regarded as comparable to those of a contract manufacturer.

C - Acceptability of comparability adjustments

25. Comparability adjustments should only be considered where they can be expected to increase the reliability of the results. This statement might seem an obvious one but it has some implications that might be worth specifically addressing in the Guidelines. The Guidelines' use of the phrase "reasonably accurate" may imply that the adjustments are merely a technical issue and focus taxpayer and revenue administration attention on the accuracy of an adjustment. However, in a number of cases a threshold issue is one of whether reliability is improved by making the adjustment, or whether the adjustment needs to be made at all.

C-1 Quality of the data being adjusted

26. First, it is not always the case that third party data deserve the proposed adjustments. Sophisticated adjustments may be questionable when basic comparability criteria are only broadly satisfied. For instance, it is not worth adjusting data for an identified difference in accounts receivable if in the first place comparability is likely to be materially affected because of significant uncertainties that could not be resolved in the accounting standards applied by the third parties. Comparability adjustments should only be applied to good quality comparables in order to improve their accuracy. If the search for comparables has major shortcomings, sophisticated adjustments should not be applied to create the wrong impression that the outcome is "scientific", reliable and accurate.

27. In a similar vein, numerous or very material adjustments to key comparability factors might not be acceptable. Too many adjustments or adjustments that too greatly affect the comparable may indicate that the third party transaction being adjusted is in fact not sufficiently comparable.

C -2 Purpose of the adjustment performed

28. Comparability adjustments are intended to eliminate the effect of differences that may exist between the situations being compared and that could materially affect the condition being examined in the methodology (e.g. price or margin). It logically follows that comparability adjustments do not need and in fact should not be performed to correct differences that have no material effect on the comparison. There will always be differences between the taxpayer's controlled transactions and each of the third party comparables. A comparison should not be rejected just because of an unadjusted difference if such difference has no material effect on the comparability. On the other hand, differences that do not materially affect the comparability should not be adjusted, otherwise the risk is to encourage adjustments that are not needed and might be mainly motivated by the desire to influence the outcome of the analysis.

C - 3 Cases where not all the transactions being compared are capable of being adjusted

29. There are adjustments that may be quantifiable in the case of a taxpayer's controlled transaction or of an uncontrolled comparable transaction, but not both (such as adjustments for goodwill or intangibles). There is an issue as to the extent to which an adjustment to either an uncontrolled comparable transaction or the taxpayer's controlled transaction may improve reliability (and therefore comparability) when similar adjustments are not able to be made for other transactions. There is also an issue when an adjustment is able to be reliably made to some potential comparables, and not to others.

C -4 Reliability of the adjustment performed

30. Some business commentators when responding to the comparability questionnaire suggested that it would be helpful to establish a clearly stated principle that a taxpayer should take reasonable efforts to adjust for comparability differences in the light of the information available. This does not mean that comparability adjustments which are not reliable and reasonably accurate might be acceptable, but is meant to repeat the need for a reasonable application of the guidance on comparability adjustments, as advocated for all aspects of the comparability analysis. The word "reasonably" is to remind taxpayers and tax administrations that they should exercise judgment before performing or rejecting an adjustment.

31. Further guidance on what constitutes a "reliable" adjustment could be useful. Reliability supposes that the amount of the adjustment should be calculated based on objective and verifiable economic data.

32. Some adjustments, which can be designated as "What if" style adjustments, relate to adjustments that seek to quantify a factor that may be relevant to a taxpayer's business, but the adjustment can only be quantified in an indirect way. For example, a taxpayer may argue that extraordinary factors affected the operation of its business but this can only be quantified by assuming that in the absence of that extraordinary factor, performance would have been different (with reference, for example, to target levels of output). These types of adjustments are likely to be highly problematic (and unlikely to improve reliability), in part because of difficulties in (a) quantification and (b) applying similar adjustments to comparables. More guidance might be needed around where adjustments for such factors would be considered to improve the reliability of the comparables outcomes.

33. A similar concern is expressed by one business commentator who believes that a distinction should be drawn between standard comparability adjustments, such as those designed to account for differences in relative levels of inventories, receivables and payables, and non standard comparability

adjustments. This commentator considers that arguably, such “standard” adjustments could be applied objectively, and should not be controversial, while some other comparability adjustments, such as those sometimes made to account for country risk, may be considerably more subjective so that it would not be unreasonable to expect more effort to be put into justifying their use. Member countries however generally do not support such a distinction as they rather consider that every adjustment should be expected to improve comparability or it should not be made. Accordingly, whichever party is proposing the adjustment should be in a position to defend its use.

34. Some countries are sceptical towards comparability adjustments in general and have expressed some doubts about the reliability of comparability adjustments which they consider in general as highly subjective and having the potential to create the wrong impression that the outcome is reliable and accurate. These countries favour a review of the definition of the search steps (e.g. narrowing the search with the geographic location instead of a geographic adjustment, narrowing the search to retailers instead of adjusting the data of wholesalers). For some countries unadjusted data, where available in sufficient number, should generally be given preference.

35. Some other countries point out that poor comparables, no matter how many, will always provide a less reliable estimate of the arm’s length range than few relatively good comparables, whether they are good because they are initially highly comparable or because they have been adjusted reliably.

36. The key issue with respect to making comparability adjustments is the reliability of the adjustment performed. This is clearly an issue involving judgment and this is another area where the judgment involves an assessment of the relative reliability of alternative transfer pricing methods (and therefore comparables as they relate to the alternative transfer pricing method).

C -5 Consequence of having performed a well focused and reliable enough adjustment

37. While adjustments should be rejected where they do not satisfy the above requirements in terms of quality of adjusted data, purpose and reliability of the adjustment performed, adjustments that do satisfy these requirements should be accepted in good faith and should not be rejected simply because they have changed the comparables’ results enough to change the range they determine.

C -6 Documentation

38. Comparability adjustments (whether performed by a taxpayer or a tax administration) are part of the comparability analysis and should be appropriately documented in order to ensure the needed level of transparency. As acknowledged by several business commentators, the taxpayer’s documentation should include an explanation of any adjustments performed, whether standard or non standard, the reasons for the adjustments to be considered appropriate, how they were calculated, and how they changed the results for each comparable. In the absence of the needed transparency, tax administrations might reject an adjustment proposed by a taxpayer.

C -7 Testing the comparability adjustment

39. Search criteria are formulated on the basis of the functional analysis of the tested party. When a comparability adjustment is made, it should be properly documented and it may be necessary to ensure that the proposed adjustment in effect improves comparability i.e. that the comparability factors are as well or better satisfied than before the adjustment was performed.

D - Preliminary conclusion on comparability adjustments and possible areas for future work

40. Even though the need to perform reasonably accurate adjustments to comparable data is mentioned throughout the Guidelines for all methods, there is limited guidance on what constitutes a “reasonably accurate adjustment”, on what type of adjustments are appropriate in what situations and how these adjustments should be handled in practice. This might be an area for further development in the Guidelines.

41. However, the Working Party as well as business commentators recognise that it is not possible – and in fact not desirable - to provide an exhaustive list of all possible adjustments and of how they should be calculated. There is also general agreement that any guidance developed on comparability adjustments should avoid being too prescriptive.

42. In view of the above, the Working Party might consider doing further work in the following two directions:

- Expand the existing guidance and develop a common platform of principles and concepts that ought to be adopted in performing comparability adjustments, including the circumstances under which they would typically be undertaken. This could be based on the discussion that is initiated under Section C above.
- Develop guidance on working capital adjustments, as this is the most commonly observed comparability adjustment. In practice, several ways to calculate the working capital adjustments are being proposed by taxpayers. Working capital adjustments are also based on the selection of an appropriate interest rate. An example of a working capital adjustment is proposed in the Annex to this Note.

ANNEX: EXAMPLE OF A WORKING CAPITAL ADJUSTMENT

Introduction:

43. This simple example shows how to make an adjustment in recognition of differences in levels of working capital between a tested party (TestCo) and a comparable (CompCo). It represents one way, but not necessarily the only way, in which such an adjustment can be calculated. These types of adjustments may be warranted when applying the transactional net margin method. In practice they are usually found when applying a TNMM, although they might also be applicable in cost plus or resale price methods. Working capital adjustments should only be considered when the reliability of the comparables will be improved and reasonably accurate adjustments can be made. They should not be automatically made and would not be automatically accepted by tax administrations.

Why make a working capital adjustment?

44. In a competitive environment, money has a time value. If a company provided, say, 60 days trade terms for payment of accounts, the price of the goods should equate to the price for immediate payment plus 60 days of interest on the immediate payment price.

45. By carrying high accounts receivable a company is allowing its customers a relatively long period to pay their accounts. In a competitive environment, the price should include an element of interest to reflect these payment terms.

46. Furthermore by allowing high accounts receivable the company would need to borrow money to fund the credit terms or reduce the amount of cash surplus which the company is able to invest. The effect of high levels of receivables is higher interest expense or reduced interest income and overstated net sales.

47. The opposite applies to higher levels of accounts payable. This tends to understate interest expense or overstate interest income. The cost of goods sold would also be overstated.

48. If a person purchases say 60 days more inventory than is the case for another person that it is being compared with, then the practical effect is that the first person's expenditure is increased by an amount equivalent to 60 days interest in comparison with that other person.

49. Making a working capital adjustment is an attempt to adjust the differences between the tested party and potential comparables in interest expenses with an assumption that the difference should be reflected in profits. The underlying reasoning is:

- A company will need funding to cover the time gap between the time it invests money (i.e. pays money to supplier) and the time it collects the investment (i.e. collects money from customers)
- This time gap is calculated as: the period needed to sell inventories to customers +(plus) the period needed to collect money from customers – (less) the period granted to pay debts to suppliers.

50. A company with high levels of inventory would need to either borrow to fund the purchase or reduce the amount of cash surplus which the company is able to invest. Note that the interest rate might be affected by the funding structure (e.g. where the purchase of inventory is partly funded by equity) or by the risk associated with holding specific types of inventory.

The process of calculating working capital adjustments:

1. Identify differences in the levels of working capital. Generally trade receivables, inventory and trade payables are the three accounts considered. TNMM is applied relative to an appropriate base, for example costs, sales or assets (see paragraph 3.26 of the Guidelines). If the appropriate base is sales, for example, then any differences in working capital levels should be measured relative to sales.
2. Calculate a value for differences in levels of working capital between the tested party and the comparable relative to the appropriate base and reflecting the time value of money by use of an appropriate interest rate.
3. Adjust the result to reflect differences in levels of working capital. The following example adjusts the comparable's result to reflect the tested party's levels of working capital. Alternative calculations are to adjust the tested party's results to reflect the comparables levels of working capital or to adjust both the tested party and the comparables results to reflect "zero" working capital.

A practical example of calculating working capital adjustments:

The following calculation is hypothetical. It is only to demonstrate how a working capital adjustment can be calculated.

TESTCO	Year 1	Year 2	Year 3	Year 4	Year 5
Sales	\$179.5m	\$182.5m	\$187m	\$195m	\$198m
Earnings Before Interest & Tax (EBIT)	\$1.5m	\$1.83m	\$2.43m	\$2.54m	\$1.78m
EBIT/Sales (%)	0.0%	0.1%	1.3%	1.3%	0.9%
Working Capital (at end of year)					
Trade Debtors	\$122.5m	\$121.9m	\$128m	\$125.6m	\$115.5m
Inventories	\$112.5m	\$112.0m	\$115.2m	\$116.6m	\$109.8m
Trade Creditors	\$190m	\$191.9m	\$207.7m	\$212m	\$203.4m
Receivables + Inventory - Payables	\$45m	\$42m	\$35.5m	\$30.2m	\$21.9m
R+I - P / Sales	25%	23%	19%	15.5%	11.1%

COMPCO	Year 1	Year 2	Year 3	Year 4	Year 5
Sales	\$120.4m	\$121.2m	\$121.8m	\$126.3m	\$130.2m
EBIT/Sales (%)	1.32%	2.96%	2.59%	3.31%	4.95%
Working Capital (at end of year)					
Trade Debtors	\$112.9m	\$103.1m	\$103.4m	\$103.8m	\$104.2m
Inventory	\$106.1m	\$106.7m	\$105.0m	\$105.3m	\$106.0m
Trade Creditors	\$184.3m	\$186.77m	\$191.3m	\$195.85m	\$189.1m
Receivables + Inventory - Payables	\$34.7m	\$23.03m	\$17.1m	\$13.25m	\$21.1m
R+I - P / Sales	28.9%	19%	14%	10.5%	16.2%
TestCo's R+I - P / Sales	25%	23%	19%	15.5%	11.1%

CompCo's R+I - P / Sales	28.9%	19%	14%	10.5%	16.2%
Difference	-3.9 %	4%	5%	5%	-5.1%
Interest Rate	4.8%	5.4%	5%	5.5%	4.5%
Adjustment	-0.18%	0.21%	0.25%	0.27%	-0.23%
Working Capital Adjusted EBIT / Sales for CompCo	1.14%	3.17%	2.84%	3.58%	4.72%

Some observations:

- An issue in making Working Capital Adjustments is what point in time are the Receivables, Inventory and Payables compared between the tested party and the comparables. The example compares their levels on the last day of the financial year. This may not, however, be appropriate if this timing does not give a representative level of working capital over the year.
- In the long run Receivables + Inventory - Payables should approach zero for a comparable. If proposed Working Capital Adjustments are significant, consideration may need to be given to whether the proposed comparable is an appropriate one.
- A major issue in making Working Capital Adjustments is the question of which interest rate to use. The rate to be used is determined by the tested party. In most cases a borrowing rate will be appropriate. In cases where the tested party's working capital balance is negative (that is Payables > Receivables + Inventory) a lending rate may be considered in some cases. The example uses an interest rate based on what TestCo is able to borrow at in the local market. This example also assumes that the same interest rate is applied to payables, receivables and inventory.
- The purpose of Working Capital Adjustments is to improve the reliability of the comparables. There is a question whether Working Capital Adjustments should be made when the results of some comparables can be reliably adjusted while the results of some others cannot.

Multiple year data

A - Existing guidance

1. Paragraphs 1.49 to 1.51 of the Guidelines address the issue of multiple year data as follows:

“In order to obtain a complete understanding of the facts and circumstances surrounding the controlled transaction, it generally might be useful to examine data from both the year under examination and prior years. The analysis of such information might disclose facts that may have influenced (or should have influenced) the determination of the transfer price. [...] Such an analysis may be particularly useful where as a last resort a transactional profit method is applied.

Multiple year data will also be useful in providing information about the relevant business and product life cycles of the comparables [...]

Data from years following the year of the transaction may also be relevant to the analysis of transfer prices, but care must be taken by tax administrations to avoid the use of hindsight [...]

2. Paragraph 3.44 further indicates that:

“Multiple year data should be considered in the transactional net margin method for both the enterprise under examination and independent enterprises to the extent their net margins are being compared, to take into account the effects on profits of product life cycles and short term economic conditions. For example, multiple year data could show whether the independent enterprises that engaged in comparable uncontrolled transactions had suffered from the effects of market conditions in the same way and over a similar period as the associated enterprise under examination. Such data could also show whether similar business patterns over a similar length of time affected the profits of comparable independent enterprises in the same way as the enterprise under examination.”

3. Paragraph 1.54 of the Guidelines also provides a specific comment relating to the usefulness of multiple year data in loss situations.

B - Comments received from the business community

4. A number of comments were contributed by the business community on the issue of multiple year data. Many commentators regarded multiple year data as useful to smooth out the fluctuations caused by business/economic life-cycles. One business commentator believes that transfer pricing policies should be established on a multiple year basis, which implies the necessity of studying multiple year data and monitoring their evolution. Another one assumes that the use of multiple year data should be the standard, rather than an exception.

5. Many commentators indicated that the 1995 TP Guidelines lacked guidance on how to use multiple year data in practice. According to some of them, it would be helpful for the OECD to provide guidance on the number of years to be considered and the way these data have to be combined or averaged because there are obviously different views on that within OECD countries. For one commentator, rolling year averages should also be accepted in order to prevent “cherry picking” of transactions or single accounting periods. For BIAC, from a theoretical perspective, the number of years of data considered should ideally cover the economic cycle of the industry in question. However, such business cycles may be hard to define and not all comparable companies selected may be in the same phase of the business cycle as the tested party. For BIAC, the Guidelines should therefore recognise the use of weighted averages, to attempt to smooth out business cycle fluctuations and other atypical volatility in company or industry data. As reflected in these comments, many business commentators link the use of multiple year data with the use of statistical tools.

C - A few considerations related to the use of multiple year data

6. Use of multiple year data is quite common in practice. Multiple year data can improve the understanding of the controlled transaction (see paragraphs 1.49 to 1.51 of the Guidelines) and help in assessing the probability of a transfer of income at the time of price setting. Multiple year data can also improve the process of selecting third party comparables e.g. by identifying results which may indicate a significant variance from the underlying comparability characteristics of the controlled transaction being reviewed, in some cases leading to the rejection of the comparable, and/or by ensuring they are at the same point as the taxpayer in the business cycle. Some countries consider that in order for third party information to be retained it is necessary that it be available for a minimum period of time (e.g. two years) and/or that comparable data should ideally cover a business cycle.

7. It is worth emphasising that:

- multiple year data should be used where (and only where) using it adds value to the transfer pricing analysis,
- it is not a systematic requirement as it is not always useful, although in practice situations where use of multiple data will not be of some use in a comparability analysis are likely to be limited,
- it should not be confused with the use of statistical tools. In particular, there will be cases where multiple year data are found useful to obtain a broader understanding of the context of a transaction, without such multiple year data being necessarily part of a mathematical determination of the arm’s length range.

Sections C-1 to C-3 below provide a few illustrations of situations where multiple year data may be useful.

8. “Data” and “information”, as seen from a close reading of paragraphs 1.49-1.51 of the Guidelines, are interchangeable in this context. Data extends beyond the observed financial outcomes of comparable transactions to information underlying the transaction, including but not limited to: terms and conditions observed at arm’s length; economic conditions at relevant times and the impact of changes therein upon outcomes, terms and conditions and transactions; the organization of transactions; the nature and role of transactions in the industry; etc.

9. “Use” and “analysis” can similarly be used interchangeably in this context. The use of multiple year data does not imply or require anything more than the application of observation and judgment. This highlights the commentators’ request for guidance on “the way this data must be combined or averaged” since there is no requirement to be able to apply statistical analysis to the data or information to be used or

analysed. Rather, the guidance indicates that all types of information relating to controlled and uncontrolled transactions may have relevance in determining the arm's length nature of the terms and conditions that obtain in the controlled transactions and in determining the degree of comparability of uncontrolled transactions to the tested transaction.

C-1 Multiple year data and cycles

10. As noted in paragraphs 1.49-1.51 of the 1995 TP Guidelines, multiple year data can be useful where a taxpayer's transactions are affected by economic/business or product cycles.

11. For instance, if a taxpayer is operating in an industry which experiences economic cycles, the use of multiple year data may be useful to:

- gain information on the cycle affecting the taxpayer's transactions (e.g. duration and amplitude of the cycle),
- identify whether potential third party comparables are subject to the same or similar cycle,
- identify whether the taxpayer and the potential third party comparables are situated at the same moment in the cycle,
- assess the effect of any significant difference between the taxpayer's and the third parties' cycles.

12. Where what is subject to a cycle is the particular product traded in a taxpayer's controlled transaction (e.g. in liaison with product life term), the use of multiple year data on both the taxpayer's product and the potential third party comparables may provide valuable information to ensure that the transactions being compared are not significantly different simply due to the products being at different moments in their respective cycles.

13. It would not be appropriate to set prescriptive guidance as to the number of years to be covered by multiple year analyses. The relevant period of time will depend on the nature of the business and the function, asset and risk profile of the taxpayer.

C -2 Multiple year data in loss-making situations

14. Multiple year data might be useful in evaluating a reasonable period of time for an enterprise to sustain loss making transactions. Where a taxpayer reports recurrent loss-making controlled transactions, multiple year data on third parties can assist in determining whether the taxpayer's loss-making period is reasonable or exceeds those of comparable independent parties (see paragraph 1.54 of the 1995 TP Guidelines).

C - 3 Use of multiple year data to examine volatility or to detect anomalies in third party data

15. Multiple year data can be used to test the volatility of third parties results, e.g. to exclude from the set of comparables those third parties that have a high volatility if the tested transaction involves only low risk functions and if the high volatility of third party comparables reflects different risk characteristics.

16. Similarly, multiple year data can be useful to detect anomalies in third party information. For example, if the third party reports extreme results in a given year this may require further investigation into the comparables to analyse what is the reason for the detected variation, which could lead to its elimination as a comparable, or may lead to its exclusion in the year in which its results are impacted by the non-comparable events.

D - Issues which should not be confused with the use of multiple year data

D-1 Adjustment of a taxpayer's profits over a multiple year period of time

17. Sections C-1, C-2 and C-3 above describe situations where the use of multiple year data is used to improve the understanding of a taxpayer's transaction and/or of its potential comparables. A different question is whether transfer pricing adjustments should be determined year on year or over a specific time period, i.e. whether a taxpayer should be subject to a transfer pricing adjustment when its transfer prices are below arm's length for one year and above arm's length for another year, but overall are reasonable over the period under examination. The answer would depend on each country's domestic examination procedures. On the one hand, most OECD countries have a rule that each fiscal year should be examined separately. On the other hand, it can be argued that some flexibility might be desirable when such a situation arises due to the complexity of the taxpayer's transfer pricing rather than to a deliberate manipulation of the level of taxable profits within a MNE group over a given period of time⁸.

D-2 Statistical tools

18. The comments received from the business community show that many commentators link the use of multiple year data with the use of statistical tools. In fact, the same shortcut is found in the 1995 TP Guidelines themselves, at paragraph 3.30:

“Application of any arm's length method requires information on uncontrolled transactions that may not be available at the time of the controlled transactions. This may make it particularly difficult for taxpayers that attempt to apply the transactional net margin method at the time of the controlled transactions (*although use of multiple year averages as discussed in paragraphs 1.49 through 1.51 [emphasis added] may mitigate this concern*) [...]”.

19. It is worth noting that the use of multiple year data does not necessarily imply the use of multiple year averages as a statistical tool. The use of multiple year data and the use of statistical tools should be considered as separate issues. For example, none of the examples in Section C above requires the use of statistical tools. In fact, while multiple year data can be used to broaden the understanding of the context of a transaction, statistical tools such as percentiles, median or averages, where they are used, are generally intended to narrow a range of results.

8 See paragraph 4.9 of the Guidelines: “In a difficult transfer pricing case, because of the complexity of the facts to be evaluated, even the best-intentioned taxpayer can make an honest mistake. Moreover, even the best-intentioned tax examiner may draw the wrong conclusion from the facts. Tax administrations are encouraged to take this observation into account in conducting their transfer pricing examinations. This involves two implications. First, tax examiners are encouraged to be flexible in their approach and not demand from taxpayers in their transfer pricing a precision that is unrealistic under all the facts and circumstances. Second, tax examiners are encouraged to take into account the taxpayer's commercial judgment about the application of the arm's length principle, so that the transfer pricing analysis is tied to business realities. [...]”

20. A discussion of statistical tools is found under a separate Note on “Definition of the arm’s length range definition, extreme results, methods to enhance reliability, loss-making comparables”.

E - Preliminary conclusion

21. It might be worth reviewing the existing guidance in the 1995 TP Guidelines on multiple year data and proceeding to:

- Complete paragraphs 1.49-1.51 by providing illustrations of situations where multiple year data may be useful. Material in Section C above could be used for this purpose;
- Clarify that the OECD recognition of the usefulness in some circumstances of multiple year data is not intended to contradict domestic examination procedures with regard to yearly assessment of taxpayers’ results,
- Clarify that the OECD recognition of the usefulness in some circumstances of multiple year data is a separate issue from the one of statistical tools and accordingly amend paragraph 3.30.

Aggregation of transactions

A. Description of the issue

1. All the OECD transfer pricing methods, whether traditional or profit based methods, are transactional methods. As a consequence, when applying the OECD transfer pricing methods, taxpayers who try to identify external comparables are faced with the difficult issue of finding information on third party transactions. Third parties rarely publicly disclose detailed information on their transactions, even on aggregated transactions at the product line level. Indeed, enterprises are generally required to disclose financial information only at the company or even group level, and information on prices or margins per transaction is often regarded as confidential business information. There is a question as to whether aggregated or even company-wide third party information can be used and if so to what extent and subject to what safeguards.

2. This issue is different from the question of a possible aggregation of the taxpayer's controlled transactions to which the transfer pricing method is applied, but is rather addressing the possible use of aggregated information on third party transactions that are used as external comparables. It should be assumed in this Note that a taxpayer is trying to find third party information to determine the arm's length remuneration of a particular controlled transaction, but faces the issue in practice of not being able to obtain sufficiently detailed information on third parties. A different question, but one which may also benefit from further guidance, is for the taxpayer to consider whether to aggregate its own transactions, e.g. if they are closely linked or continuous (see paragraph 1.42 of the Guidelines). Specifically, there may be cases where aggregated third party transactions might provide a valid comparable for one particular, non-aggregated, transaction of the taxpayer. Aggregation of third party transactions and aggregation of a taxpayer's transactions must be decided separately in light of the conditions of the transactions to be aggregated.

3. In effect, paragraph 1.42 of the Guidelines already provides some guidance for the evaluation of a taxpayer's combined transactions in cases where separate transactions are so closely linked or continuous that they cannot be evaluated adequately on a separate basis:

“Ideally, in order to arrive at the most precise approximation of fair market value, the arm's length principle should be applied on a transaction-by-transaction basis. However, there are often situations where separate transactions are so closely linked or continuous that they cannot be evaluated adequately on a separate basis. Examples may include 1. some long-term contracts for the supply of commodities or services, 2. rights to use intangible property, and 3. pricing a range of closely-linked products (e.g. in a product line) when it is impractical to determine pricing for each individual product or transaction. Another example would be the licensing of manufacturing know-how and the supply of vital components to an associated manufacturer; it may be more reasonable to assess the arm's length terms for the two items together rather than individually. Such transactions should be evaluated together using the most appropriate arm's length method or methods. A further example would be the routing of a transaction through another associated enterprise; it may be more appropriate to consider the transaction of which the routing is a part in its entirety, rather than consider the individual transactions on a separate basis.”

4. Paragraph 1.42 however does not cover the issue of third party transactions that are aggregated because third party information is not available at the transaction level.

5. Let us take an example whereby the controlled transaction under analysis is the purchase by a taxpayer of a particular variety of cookies. The taxpayer has a buy-and-sell activity in its territory, i.e. cookies are re-sold to unrelated retailers. Assume that in this case the CUP method is found unreliable because data pertaining to prices charged in comparable transactions between unrelated parties cannot be found or properly adjusted. Assume the resale price method is selected to determine whether or not the prices paid by this taxpayer to its related party suppliers are at arm's length. Assume there is no internal comparable and that a search for external comparables is needed. In order to do so, the taxpayer searches for data pertaining to unrelated parties that carry out a similar buy-and-sell activity in comparable circumstances. When looking for financial information on competitors, it is very unlikely that any data would be available at transaction level. The only third party information that might be available would be information at a company level, that is the gross or net profit margin earned by third party re-sellers on the distribution of their product portfolios. Such information is likely to encompass a variety of transactions on a range of products (e.g. a range of different types of cookies, maybe also some other food products) with a variety of customers (and therefore potentially a variety of business strategies and contractual terms). It is in effect very rare that an independent enterprise limits its activity to a single type of transaction.

6. In this respect, there is a difference between the CUP method and the other OECD transfer pricing methods. When applying the CUP method, it is in principle not possible to overcome the need to rely on transactional information. This is because information on aggregated transactions (e.g. at company level) is generally meaningless when looking for the price of a particular transaction. For instance, when looking for the price of a particular electronic device, information on the aggregated sales revenue of a third party that sells electronic devices is not relevant (unless this third party company is known to sell only one particular type of electronic device and information is available on the exact quantity of devices sold – which is an unlikely situation). In cases where information at the transactional level cannot be found, taxpayers would not be able to use the CUP method and would select another method.

7. By contrast, when applying the resale price method, cost plus method, profit split method or TNMM, it is found that practitioners, in practice, often try to overcome the difficulty by comparing the gross or net profit margin arising from their particular controlled transactions with the gross or net profit margins earned on aggregated transactions performed by independent enterprises performing comparable activities. The transactions of these independent enterprises are often aggregated at the level of the legal entity that implements them. Practitioners tend to consider that the transactional focus of the Guidelines is arguably retained, at least to some extent, by ensuring that the comparisons are made with third parties that exclusively or mainly undertake the type of transaction under analysis.

B. Business comments received

8. Most of the business commentators who responded to the OECD comparability questionnaire stressed that the analysis of third party transactions is a real issue in practice due to the difficulty to find third party transactional level data relevant to a transfer pricing analysis. They state that publicly available information is not at a transactional level and is not revealing of the circumstances that led to a certain pricing decision which is reflected in the margin. For some commentators, there may not always be a relevant difference between third party transactional data and third party company-level data, which they consider should be acceptable unless transactional data are available and provide a more reliable measure.

C. The OECD view

9. When discussing these issues, OECD countries have pointed out that, all else being equal, aggregation of third party transactions generally reduces the reliability of a comparability analysis, and that a transactional analysis would generally be preferred where transactional data are available. However, in practice such data may not be available. OECD countries agreed that there was a need to recognize that in practice there are circumstances in which aggregated comparable data should be used, but only where its use provided the most reliable available evidence to inform the arm's-length nature of transfers between associated enterprises.

10. The Working Party is of the opinion that the requirement of a transactional analysis should be retained as the starting point in any comparability analysis, and that more guidance may be necessary on how aggregated information on third party transactions could best be used within this framework.

11. Experience indicates that if use of highly aggregated or even company-wide data became the general rule, some comparables might become regularly used in certain types of cases. For example, if a low risk distributor is being examined, there might be on the market concerned only a few potential comparables that have information publicly available and undertake low risk distribution functions. Inevitably, the application of transfer pricing principles could become more formulaic if the tests in the Guidelines were weakened in this manner. A shift in emphasis to allow highly aggregated data (to the extent that companies' profit results are aggregated) as the normal position is not desirable as it could be seen as an endorsement of that approach.

12. Part of the solution might lie in providing further guidance on the circumstances in which aggregation of third party transactions would be acceptable in a comparability analysis. The objective should be both to limit any exaggeration or underestimation of the burden created by transfer pricing documentation requirements, and to develop a principled and practical position with respect to the aggregation of third party data.

13. The Working Party considers that third party transactions could be aggregated in a comparability analysis where they form an aggregate of comparable transactions that are subject to the same economic factors and decision making process or, in general, are in compliance with the requirements of a proper comparability analysis. The appropriate level of aggregation/segregation is a matter of judgment, with the overall objective being to determine the level of aggregation that provides the closest comparability to the controlled transactions. This is in substance the message contained in the current wording of paragraphs 1.42 to 1.44 with respect to a taxpayer's own transactions, pointing out the need in some cases to combine transactions that form a continuum, and in other cases to separate transactions that might be contracted as a package deal. The same point could be addressed concerning the aggregation of third party transactions by adding new guidance in the Guidelines and possibly developing an example. One difference though when looking at third party comparables is the practical difficulty of segregating information that is available on an aggregated basis. Thus, the practical issue may be to a lesser extent the consideration of aggregating individual transactions, but rather whether information on third party potentially comparable aggregated transactions can be reasonably segregated.

14. The transactional focus of OECD transfer pricing methods does not mean that transfer pricing should be analysed at the level of each individual sale. Assume that a manufacturer sells 1 million fluorescent light bulbs to a related party in a year. Assume that for some reason it is not possible to apply a comparable uncontrolled price method in this case and that either a cost plus or resale price method is applied. In doing so, the taxpayer should not be regarded as having performed one million related party transactions that need to be separately analysed for transfer pricing purposes.

15. Assume now that a taxpayer has entered into controlled transactions consisting of the importation of blenders from its related party and the resale of these blenders to unrelated end-users. Assume that in the absence of an acceptable CUP, the resale price method is selected to determine whether the purchase price paid by the taxpayer to related parties is at arm's length. Assume a search for external comparables is performed and several potential external comparables are identified, among which an independent party, THE INDEPENDENT COMPANY is identified as performing potentially comparable uncontrolled transactions. THE INDEPENDENT COMPANY has a retail activity of selling blenders to end-user customers. THE INDEPENDENT COMPANY is found to have dozens of different references of blenders in stock (some of them are also sold by the taxpayer, while some others are not), dozens of third party suppliers and 10,000 end-user customers. It would not be necessary to examine each individual purchase of each individual product reference by THE INDEPENDENT COMPANY from each individual supplier. Rather, one should exercise judgment and determine whether the purchase and sale of these different blenders by THE INDEPENDENT COMPANY are subject to the same or similar economic factors and decision-making process and therefore can be regarded as one transaction, potentially comparable to the taxpayer's transactions, or whether they should be further segregated.

16. Assume now that the taxpayer engages in two different kinds of transactions, i.e. the purchase and resale of blenders and the purchase and resale of toasters. In addition to the question described in the above paragraph, a further question would be whether aggregated transactions of THE INDEPENDENT COMPANY can be used as a comparable to assess the aggregated transactions of the taxpayer (i.e. blenders plus toasters) or only for the blenders activity. The conclusion would be that the determination whether or not aggregated transactions of THE INDEPENDENT COMPANY are to be used as a comparable is made only after having examined whether or not the taxpayer's own transactions can be aggregated. Depending on the facts and circumstances, the result could be that the segregated taxpayer's transaction is compared with aggregated transactions of THE INDEPENDENT COMPANY.

17. One circumstance where third party data that are aggregated at company level might be useful is where the third party is found to engage in a single type of transaction which satisfies the aggregation criterion defined above. By contrast, aggregated company-level data might not provide a satisfactory comparable if the third party has carried out, in addition to the type of transaction being compared, another type of transaction that (i) has a different economic and business profile and (ii) has a material impact on the data.

18. Going back to the example at paragraph 15 above, assume now that in addition to blenders, THE INDEPENDENT COMPANY also sells toasters. In this example it is assumed that due to the unavailability of an acceptable CUP and of information at gross margin level, a transactional net margin method is being applied. Assume that due to the format of filing requirements in the country where THE INDEPENDENT COMPANY is operating, the taxpayer is unable to obtain segregated data that would differentiate between the net margins earned by THE INDEPENDENT COMPANY on its sales of blenders and the net margins earned on toasters. The question is whether the aggregated, company-wide net margin of THE INDEPENDENT COMPANY can be used by the taxpayer in the comparability analysis for its blenders activity. This would not necessarily be the case, and the answer would depend on whether or not it can be reasonably assumed that (i) either the five comparability factors are satisfied by the sales of toasters, in particular these sale transactions have a similar functional analysis and have similar economic characteristics as the sales of blenders, which might be very difficult to demonstrate in practice, or (ii) they represent a negligible portion of the total activity of THE INDEPENDENT COMPANY.

19. Reference can be made to the existing wording of paragraph 3.42 of the Guidelines which states, with respect to the application of the transactional net margin method, that: "Therefore, it would be inappropriate to apply the transactional net margin method on a company-wide basis if the company

engages in a variety of different controlled transactions that cannot be appropriately compared on an aggregate basis with those of an independent enterprise.”.

20. Using aggregated third party data in some circumstances should not in any event be interpreted as allowing a comparison of two companies (a taxpayer and a third party company) just because they belong to the same industry sector. This would be unacceptable, in particular because it would not take account of the differences in intangibles, risks, and organisational models of the enterprises. In fact, as suggested in the comments received from one business commentator, this might be both inappropriate and dangerous because it might suggest the use of industry averages. For instance, it would not be consistent with the arm’s length principle to make company wide comparisons of all distributors of consumer goods or company wide comparisons of all manufacturers of electronic products without giving proper regard to whether the transactions performed by these companies satisfy the comparability factors as well as the aggregation criteria.

21. Moreover, the recognition that company-wide data might be used in some cases should not be interpreted as allowing the use of TNMM on an aggregated basis without paying proper regard to potential internal comparables, traditional transaction methods, and to what level of aggregation is acceptable as discussed above. As indicated in paragraph 3.50 of the Guidelines, “[...] even in a case of last resort, it would be inappropriate to automatically apply a transactional profit method without first considering the reliability of that method. [...] Thus, if it is necessary to aggregate transactions to apply a transactional profit method and if it is possible to aggregate the same transactions and apply a traditional transaction method, the effect of such aggregation on the reliability of both methods must be considered [...]”.

22. Note also paragraph 3.54 of the Guidelines: “[...] As with any method, it is important that it be possible to calculate appropriate corresponding adjustments when transactional profit methods are used, recognising that in certain cases corresponding adjustments may be determined on an aggregate basis consistent with the aggregation principles in Chapter I.”

23. Finally, where a taxpayer considers that its own transactions or the transactions of third parties can be validly aggregated, the reasons for such an aggregation should be made explicit in the transfer pricing documentation.

Definition of the arm's length range, extreme results, methods to enhance reliability, loss-making comparables

A - Definition of the arm's length range

1. The arm's length range is defined in paragraphs 1.45 to 1.47 of the 1995 TP Guidelines as follows:

“1.45 In some cases it will be possible to apply the arm's length principle to arrive at a single figure (e.g. price or margin) that is the most reliable to establish whether the conditions of a transaction are arm's length. However, because transfer pricing is not an exact science, there will also be many occasions when the application of the most appropriate method or methods produces a range of figures all of which are *relatively equally reliable* [emphasis added]. In these cases, differences in the figures that comprise the range may be caused by the fact that in general the application of the arm's length principle only produces an approximation of conditions that would have been established between independent enterprises. It is also possible that the different points in a range represent the fact that independent enterprises engaged in comparable transactions under comparable circumstances may not establish exactly the same price for the transaction. However, in some cases, not all comparable transactions examined will have a relatively equal degree of comparability. Therefore, the actual determination of the arm's length price necessarily requires exercising good judgment. [...]

1.46 A range of figures may also result when more than one method is applied to evaluate a controlled transaction. For example, two methods that attain similar degrees of comparability may be used to evaluate the arm's length character of a controlled transaction. [...]

1.47 Where the application of one or more methods produces a range of figures, a substantial deviation among points in that range may indicate that the data used in establishing some of the points may not be as reliable as the data used to establish the other points in the range or that the deviation may result from features of the comparable data that require adjustments. In such cases, further analysis of those points may be necessary to evaluate their suitability for inclusion in any arm's length range.”

2. Arm's length ranges, in the sense that each point in the range is equally comparable, are rarely found in practice. It is more common to encounter an approximation of an arm's length range, often developed through use of a transactional profit method. This has given rise to a concern that the current guidance on range in the 1995 TP Guidelines may need to be reviewed.

3. It should be emphasised that the application of statistical tools or other approaches to an arm's length range is not intended to make up for low quality of comparables – i.e. the idea is not to replace quality with quantity. The analysis and application of results observed from comparable transactions between unrelated parties is a necessary step in performing a transfer pricing analysis. The analysis of the observations in the range should be based on comparability criteria determined during the functional and economic analysis of the related party transaction under review.

4. In the rest of this note the following issues related to the definition of the range are briefly discussed:

- Comparability considerations in relation to extreme results
- Approaches to enhance reliability of the arm's length range
- Loss making comparables

B - Extreme results: comparability considerations

5. In practice extreme results (i.e. those which are significantly different from the majority of results obtained) are often excluded by practitioners on the grounds that they are not representative of normal business conditions. Extreme results might consist in losses or in unusually high profits.

6. Extreme results can affect the financial indicia which are looked at in the chosen method (e.g. the gross margin when applying a resale price or cost plus method, the net margin when applying a transactional net margin method). They can also affect other items e.g. exceptional items which are below the line but nonetheless may reflect exceptional circumstances.

7. Where one or more of the potential comparables have extreme results, further examination would be needed to understand the reasons for such extreme results. The reason might be a defect in comparability, or exceptional conditions met by an otherwise comparable third party. When extreme results reflect a defect in comparability they should obviously be excluded. When they reflect exceptional circumstances, they should also be excluded because they cannot be regarded as providing a workable basis for a comparison with transactions that took place in the same or similar conditions as the taxpayer's controlled transactions. Any subjective decision to include or reject extreme results would need to be considered in light of comparability factors. Where insufficient information is available to determine that the comparability factors have been satisfied, extreme results might be rejected. Extreme results may also need to be considered in the context of the number of potential comparables. When the number of potential comparables is small the question arises as to how to determine if a result is extreme. Extreme results may reflect facts and circumstances that would call into question the level of comparability with the taxpayer. An extreme result may be excluded on the basis that a previously overlooked significant comparability defect has been brought to light, not on the sole basis that the results arising from the proposed "comparable" merely appear to be very different from the results observed in other proposed "comparables" (although this information may warrant further analysis into whether there may be exceptional circumstances as discussed above). Extreme results might be rejected in comparability terms, but not solely because they are extreme.

C - Approaches to enhance reliability

8. Some countries have developed approaches that can be used, once all efforts have been made to ensure that identified potential comparables satisfy the comparability factors, in an effort to enhance the reliability of the arm's length range. The rationale for using such approaches is that either some comparability defects may remain that are not quantifiable and therefore not adjusted, or that not all the points in the range are equally comparable. Two of these approaches are described below for illustration purposes. Business comments are particularly invited on these two approaches as well as on any other possible approach to enhance reliability.

C.1 Extreme results: reliability considerations and use of statistical tools

9. Statistical tools that are found to be used in practice include percentiles (such as for instance the interquartile range), averages, weighted averages, use of pooled data points for a number of comparables over a multiple year period, medians, etc. Countries have contrasting experiences and practices in this

respect. A view was expressed that the use of pooled data points may have merit, particularly where the number of potential comparables is small as a relatively large number of data points will make use of statistical tools more meaningful.

10. There is a consensus among OECD countries that statistical tools cannot replace the comparability analysis and in any case recourse to statistical tools, where acceptable, would only come after the review of comparability factors. Use of statistical tools should not be encouraged unless they demonstrably enhance the quality of the analysis. In fact, it seems useful to re-emphasise that transfer pricing is a matter of judgment and the use of statistical tools should not be indiscriminate. An example of indiscriminate use of statistical tools would be where the analysis relies on rudimentary “statistics” automatically generated by software without judgment being exercised, notwithstanding the quality of the set of data and the number of “comparables” in the set.

11. One further point of general consensus is that statistical tools are often inappropriate for relatively small samples of data as they require a sizeable population of observations to be meaningful. Given that statistical tools can only be used after the review of comparability factors, it would not be acceptable to include poor quality comparables in a relatively small sample of observations in order to obtain a sizeable population and apply statistical tools.

An example of a statistical tool: the interquartile range

12. The “interquartile range” is a specific example of a statistical tool and all the general observations above concerning the use of statistical tools apply to interquartile and other similar ranges.

13. Many comments were received from business representatives on statistical tools, concentrating in particular on the interquartile range. They reflect a variety of views:

- Some business commentators are against the use of the interquartile range and consider that if the selected third party transactions do not all satisfy the tests of comparability then they should not be included in the range in the first place.
- Some other commentators are in favour of the use of statistical tools in circumstances where it is appropriate, e.g. when relatively large numbers of third party transactions have been identified as potentially comparable to the controlled transaction; in such cases they would assume that the ones with converging results are in some way more comparable than those at the extremes.
- Finally, a number of commentators advocate a flexible approach according to which the use of statistical tools should be decided depending on the quality of data used and distribution of data.

14. Some OECD countries make little or no use of statistical tools and do not rely on statistical tools to identify the limits of the arm’s length range to be used in the analysis. For these countries, when the quality of the (adjusted) comparables is such that an arm’s length range is found, the full range should be taken into consideration. See Section C-2 for a description of a possible approach when the available comparable transactions continue to have comparability defects.

15. Some other OECD countries consider that statistical tools that take account of central tendency, such as the interquartile range, might be allowed to enhance reliability in the face of imperfect comparables for which unquantifiable material differences between the controlled and uncontrolled transactions may

exist, notwithstanding the fact that they are the best comparables available. For these countries, the interquartile range is a tool that is meant to facilitate, rather than replace, judgment.

16. Finally, some countries with relatively small markets have limited experience of statistical tools because they do not generally have large enough sets of comparable third parties to apply statistical tools.

C.2 Ranking the points in the range

17. Some countries consider that, in the context of a comparability analysis, there is very limited scope for the use of statistical tools to assist in either the selection of a single point representing an arm's length outcome or the demarcation of an acceptable arm's length range (or approximation thereof) and that it is difficult to see how the application of analytical tools that do not measure or report on the basis of comparability can enhance comparability or assist in the completion of a comparability analysis.

18. Some countries consider that one way to do so is to qualitatively rank the comparables. For these countries, when all uncontrolled transactions that provide no useful comparable information have been eliminated due to their lack of comparability, what remains are uncontrolled transactions that provide varying degrees of useful comparable information. To the extent possible, the comparable information in the remaining transactions should be used to rank the transactions on a comparability basis. These countries consider that since comparability is a multidimensional concept, ranking transactions on the basis of comparability will require a multidimensional analysis involving a number of comparability factors. The resulting ranking is not usually as simple as a linear determination of most to least comparable on the basis of any one comparability factor. Rather, the information available from each transaction must be weighed separately to determine an overall qualitative rank indicating how valuable the information is and how the information, along with the non comparable information, may be expected to impact the results. These countries consider that, from the analysis of each controlled transaction, it may be possible to determine an approximation of an arm's length range, and/or to determine a specific result or results that would be considered arm's length for the tested transaction.

19. Some other countries have expressed concerns about the practicality of such an approach and about the validity of its outcome given the subjective nature of the process it involves.

D - Loss making comparables

D.1 Business comments

20. Many comments were received from business commentators on whether loss-making activities can be retained in the list of potential comparables or systematically rejected. Despite their apparent diversity, it seems possible to summarise these comments as follows.

21. In general, business commentators consider that the principle that the taxpayer should use all relevant information suggests that there should not be an overriding rule on the inclusion or exclusion of loss-making comparables. Indeed, it is the facts and circumstances surrounding the company in question that should determine its status as a comparable, not its financial result. As pointed out by some commentators, "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."

22. Business commentators however recognise that loss-making activities need to be closely examined before being accepted as a comparable. They put forward two circumstances in which loss-making activities should be excluded from the list of comparables:

- First, where losses do not reflect normal business conditions, as they recognise that persistent loss-making situations deserve particular attention in order to establish whether they should be retained or eliminated as comparable/non-comparable. In particular one commentator notes that loss companies that are under bankruptcy protection, for instance, should not be admitted as comparable, as their losses are not occurring under normal operating conditions.
- Second, where the losses incurred by third parties reflect a level of risks that is not comparable to the one assumed by the taxpayer in its controlled transactions. For one commentator, “Except in start-up situations, loss companies generally will not be appropriate comparables for controlled companies, because they obviously have borne more risk than controlled companies normally are expected to bear.” As indicated by another one, “In certain circumstances, e.g. if the tested party is an entity that bears only very low risks, a loss-making comparable may indicate that it is not truly comparable with the tested party and therefore has to be excluded.”

23. Business commentators who responded to the comparability questionnaire are of the view that, in those cases where the taxpayer performs simple or low risk functions which lead to excluding loss-making activities from the comparison, high profit activities may also need to be excluded for the same reasons, i.e. difference in the risk profile. The argument set forth is that in arm’s length conditions relatively high profits are as much a sign of risk as losses. Therefore, systematically excluding loss companies without also excluding high profit companies would create ranges with a systematic upward bias.

D.2 Countries’ comments

24. When discussing loss-making situations, Member countries expressed their view that an independent enterprise would not continue loss-generating activities unless it has reasonable expectations of future profits. Simple or low risk functions in particular are not expected to generate losses for a long period of time.

25. This does not mean however that loss-making transactions can never be comparable. Generally speaking a loss-making transaction should trigger further investigation in order to establish whether or not it can be a comparable. It may be, for example, that the potential comparable is undergoing a major restructure, for example acquiring or disposing of divisions, which has led to sustained losses. In considering the inclusion of loss-making transactions or businesses as comparable the following factors may need to be considered:

- the impact of a greater level of risk for the comparable relative to the tested party,
- the fact that losses may not reflect normal business conditions and
- the fact that losses may reflect different functional profiles between the potential comparable and the tested party.

A similar investigation should be undertaken for potential comparables returning abnormally large profits relative to other potential comparables.

26. The summary of business comments in sub-Section D.1 above might provide a good basis for developing an OECD position on this issue. However, countries expressed some disagreement with the

arguments made by business commentators as summarised in the second bullet point of paragraph 22 above and at paragraph 23. Specifically, the concern is that loss-making or high profit situations should not be *deemed* to reflect higher risk profiles. The direction of argumentation should rather be that the proposed comparables perform more (fewer) functions, using greater (fewer) assets, and/or assuming greater (fewer) risks than the tested party, therefore profits observed in the proposed comparables overstate (understate) those that would be expected in the tested party.

Documenting a search for comparables

1. The purpose of this Issues note is not to discuss transfer pricing documentation requirements in general. The discussion in this note is limited to documentation of searches for comparables and in particular for external comparables.

A- Existing Guidance

2. There is little guidance on the documentation of comparables in the 1995 TP Guidelines. There is a general principle in the Guidelines that taxpayers should maintain and be prepared to provide documentation regarding how their transfer prices were established (see in particular paragraphs 1.68 and 5.4 of the 1995 TP Guidelines). As a consequence, and even though this is not explicit in Chapter V, it would seem reasonable to expect that where comparables are used to establish transfer prices, they should be adequately documented.

3. Paragraph 5.6 indicates that:

“In considering whether transfer pricing is appropriate for tax purposes, it may be necessary in applying principles of prudent business management for the taxpayer to prepare or refer to written materials that would not otherwise be prepared or referred to in the absence of tax considerations, including documents from foreign associated enterprises. When requesting submission of these types of documents, the tax administration should take great care to balance its need for the documents against the cost and administrative burden to the taxpayer of creating or obtaining them. *For example, the taxpayer should not be expected [...] to engage in an exhaustive search for comparable data from uncontrolled transactions if the taxpayer reasonably believes, having regard to the principles of this Report, either that no comparable data exists or that the cost of locating the comparable data would be disproportionately high relative to the amounts at issue [emphasis added].*”

4. The Guidelines however do not discuss this in greater detail and in particular do not impose a requirement for the taxpayer to document why it reasonably believes, having regard to the principles of this Report, either that no comparable data exist or that the cost of locating the comparable data would be disproportionately high relative to the amounts at issue.

5. Paragraph 5.17 of the Guidelines currently indicates that:

“An analysis under the arm’s length principle *generally requires* [emphasis added] information about the associated enterprises involved in the controlled transactions, the transactions at issue, the functions performed, *information derived from independent enterprises engaged in similar transactions or businesses* [emphasis added], and other factors discussed elsewhere in this Report, taking into account as well the guidance in paragraph 5.4. Some additional information about the controlled transaction in question could be relevant. This could include the nature and terms of the transaction, economic conditions and property involved in the transactions, how the product or service that is the subject of the controlled transaction in

question flows among the associated enterprises, and changes in trading conditions or renegotiations of existing arrangements. It also could include a description of the circumstances of any known transactions between the taxpayer and an unrelated party that are similar to the transaction with a foreign associated enterprise and any information that might bear upon whether independent enterprises dealing at arm's length under comparable circumstances would have entered into a similarly structured transaction. Other useful information *may* [emphasis added] include *a list* [emphasis added] of any known comparable *companies* [emphasis added] having transactions *similar* [emphasis added] to the controlled transactions.”

6. The drafting of paragraph 5.17 raises a few comments:

- It does not contain any clear reference to internal comparables,
- While information derived from independent enterprises engaged in similar transactions or businesses is “generally required”, documenting third party comparables is said to be potentially useful but not compulsory;
- Where such information is found useful, only the list of comparables is mentioned, not the process that led to the identification of the comparables and assumptions which were made in the comparability analysis;
- External comparables are referred to as “comparable companies having transactions similar to the controlled transactions”; it might be more in line with the rest of the Guidelines to refer to “uncontrolled transactions comparable to the controlled transactions”.

7. Where comparables are used by a taxpayer (or a tax administration), it would seem reasonable that they be supported by appropriate documentation in order for the other interested party (i.e. tax auditor, taxpayer or foreign competent authorities) to be able to assess the quality of the comparables used.

8. The October 1999 Annex which provides guidelines for conducting advance pricing arrangements under the mutual agreement procedure (“MAP APAs”) contains a discussion of supporting information and documentation that may be of general relevance for MAP APAs, including comparable pricing information which can be of relevance to transfer pricing documentation in general (see paragraph 40 of the Annex):

“The taxpayer should include a discussion of the availability and use of comparable pricing information. This would include a description of how the search for comparables was carried out (including search criteria employed), what data relating to uncontrolled transactions was obtained and how such data was accepted or rejected as being comparable. The taxpayer should also include a presentation of comparable transactions along with adjustments to account for material differences, if any, between controlled and uncontrolled transactions. In cases where no comparables can be identified, the taxpayer should demonstrate, by reference to relevant market and financial data (including the internal data of the taxpayer), how the chosen methodology accurately reflects the arm's length principle.”

9. Based on experience acquired since the Guidelines were released in 1995, it could be useful to complete the existing guidance in Chapter V to include a discussion of documentation of the process for searching and adjusting internal as well as external comparables, including the process that led to the selection (or rejection) of comparables.

B - Contributions received from the business community

10. Business commentators are well aware of the need to document comparability analyses as reflected in many of the contributions received in response to the comparability questionnaire.

11. There is general support among business commentators for a transparent and documented process. While recognising that a certain degree of subjectivity may enter into a search process, commentators advocate for a consistently applied and objectively determined search strategy that should avoid “cherry picking” of potentially comparable companies. They recognise the importance of well-documented search procedure and comparability assessment criteria to make the comparability standard transparent and discourage cherry picking by both taxpayers and tax authorities.

12. In general business commentators who responded to the comparability questionnaire would favour developments in the TP Guidelines to clearly emphasize the need for documentation and an explanation of the search process, while taking into account some of the inherent difficulties in obtaining publicly available information in various jurisdictions.

C- Structure of a transfer pricing (comparability) study

13. Countries and taxpayers might see value in the development of guidance on how a transfer pricing analysis might best be structured to evaluate and use external comparable data (or more generally to effectively arrive at an arm’s length result).

14. As a discussion of transfer pricing documentation in general is not within the scope of this note, the comments below concentrate on the possible elaboration of documentation standards for the comparability analysis.

15. One obvious suggestion is that if documentation is designed to allow the evaluation of comparables used in a transfer pricing study, it would not be sufficient just to provide a list of “comparables”. It would seem fair to consider that where internal or third party comparables are used by a taxpayer to support its transfer pricing policy (or by a tax administration to support a transfer pricing adjustment), supporting documentation should be provided describing and explaining the process followed to arrive at a particular list of comparables and the arm’s length range.

16. A separate note “Selecting or rejecting third parties or third party transactions: degree of objectivity of the list of external comparables” contains a description of a typical process for identifying comparable transactions and for using the data so obtained. The intention is not to be prescriptive as to the process to be followed. Where a transfer pricing study relies on comparable information which has been obtained following such a process (which does not need to be exactly the same as the one described in the above mentioned note), it would be reasonable to expect each of the steps to be documented (i.e. described and explained) in order to make it possible for the tax administration auditing it to assess the quality of the analysis. Otherwise, it is difficult to see how the transfer pricing study in question could be regarded as convincing.

17. For instance, if a taxpayer uses multiple year data on the grounds that its transactions are affected by cycles, it would seem reasonable to expect the taxpayer to provide some documentation explaining why it is considered that there is a cycle, what type of cycle it is (business cycle, product cycle...), what the duration of the cycle is and where the controlled enterprise is situated in that cycle. The qualitative and quantitative criteria used to select or reject comparables should be carefully documented, as they are inevitably to some extent subjective and have a great influence on the outcome of the study. Where a taxpayer considers that no comparable data exists or that the cost of locating the comparable data would be disproportionately high relative to the amounts at issue (see paragraph 5.16 of the 1995 TP Guidelines), the

reasons supporting this judgment should be explained. Similarly, where a taxpayer makes comparability adjustments, it would seem reasonable to require a description of the adjustment performed and an explanation of why and how they were performed.

18. The same applies in fact to each of the steps of the process followed. This should not impose significant additional documentation requirement on taxpayers in the sense that it would not impose any additional search for information, but rather a requirement to keep track of a process that is followed anyway if a comparability analysis is done.

19. Specific comments on documentation issues raised in relation to sources of information are found in a separate note on “Determination of available sources of information and of their reliability”; a discussion of documentation requirements in relation to selection criteria and objectivity of the list of comparables is found in the note “Selecting or rejecting third parties or third party transactions: degree of objectivity of the list of external comparables”; and documentation requirements of comparability adjustments are discussed in a note on “Determination of and making comparability adjustments where appropriate”.

D- Preliminary conclusion on documentation issues

20. The OECD might develop guidance on how a transfer pricing analysis might best be structured to evaluate and use external comparable data. The steps outlined in the note on “Selecting or rejecting third parties or third party transactions: degree of objectivity of the list of external comparables” might provide a useful framework for such guidance.