*Mayra O. Lucas Mas and Giammarco Cottani**

OECD Proposed Revision of Chapters I-III of the OECD Transfer Pricing Guidelines: Business Comments on Selected Issues

On 9 September 2009, the OECD released for public comment the Proposed Revision of Chaps. I-III of the OECD Transfer Pricing Guidelines. The latest input from private stakeholders, which has been sought throughout the different phases of this project, is currently being analysed by the OECD, which has the intention to finalize the project by the end of 2010. This article examines most relevant comments on a selection of proposed changes.

1. Introduction

This article will provide an overview of the main areas of interest arising from the business comments received on the Proposed Revision of Chaps. I-III of the Transfer Pricing Guidelines (Proposed Revision). The document was released in September 2009, with an open invitation for public comment by January 2010. Its aim is to significantly update the current guidance as contained in the 1995 Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (OECD Transfer Pricing Guidelines) In particular, it proposes to change the hierarchy of the transfer pricing methods and to address in greater detail comparability issues and the application of the transactional profit methods.

Over 30 stakeholders, between business and non-governmental interested parties, have submitted comments. The Proposed Revision, which has been largely welcomed and is considered by commentators as a major accomplishment, adopts a more practical approach and reflects better the business realities than Chaps. I and III did before.

Working Party No. 6 of the OECD Committee on Fiscal Affairs, which is the OECD body responsible for the OECD Transfer Pricing Guidelines, met in March 2010 and will meet again in June to discuss comments received and finalize the new proposed guidance by the end of 2010.

This article provides a summary of the most relevant comments on a selection of proposed changes.

2. Background and Scope of the Proposed Revision of Chaps. I-III of the 1995 OECD Guidelines

The Council Recommendation on the Determination of Transfer Pricing between Associated Enterprises[1] contains a mandate from the Council to the Committee on Fiscal Affairs to:

> monitor the implementation of the 1995 Report as amended, in cooperation with tax authorities of member countries and with the participation of the business community and to recommend to the Council to amend and update, if necessary, the 1995 Report as amended, in light of this monitoring.

In the context of this mandate, Working Party No. 6 has undertaken a major project focused on two areas, intrinsically linked, which were considered of great priority, namely:

– comparability issues encountered when applying the transfer pricing methods authorized by the OECD Transfer Pricing Guidelines (whether traditional transaction methods or transactional profit methods); and
– the application of transactional profit methods (i.e. the transactional profit split method and the transactional net margin method).[2]

From the outset of this project, the involvement of the business community and other interested non-governmental stakeholders has played a key role in the review and development of new guidance in these two areas.

The topic of comparability was the first one to be addressed, with an open invitation for comments in April 2003. Considering the comments received and the experience acquired by countries since the adoption of the OECD Transfer Pricing Guidelines, Working Party No. 6 developed a series of draft issues notes, which addressed twelve key topics:

– putting a comparability analysis and search for comparables into perspective;
– timing issues in comparability;
– internal comparables;

* Mayra O. Lucas Mas is a Transfer Pricing Advisor at the Tax Treaty, Transfer Pricing and Financial Transactions Division of the OECD's Centre for Tax Policy and Administration. The author can be contacted at Mayra.Lucas@oecd.org. Giammarco Cottani is a Transfer Pricing Advisor at the at the Tax Treaty, Transfer Pricing and Financial Transactions Division of the OECD's Centre for Tax Policy and Administration. The author can be contacted at Giammarco.Cottani@oecd.org.

1. Recommendation of the Council on the Determination of Transfer Pricing between Associated Enterprises [C(95)126/Final] as amended on 11 April 1996 [C(96)46/FINAL], 24 July 1997 [C(97)144/FINAL], 28 October 1999 [C(99)138] and 16 July 2009 [C(2009)88]
2. All documents cited in this section (i.e. draft issues notes, discussion drafts and public comments received on both projects) can be found in the Transfer Pricing section of the OECD Centre for Tax Policy and Administration´s website at www.oecd.org/ctp/tp/cpm.

- determination of available sources of information and of their reliability;
- uncontrolled transactions;
- examining the five comparability factors;
- selecting or rejecting third parties or third-party transactions – degree of objectivity of the list of external comparables;
- determination of and making comparability adjustments where appropriate;
- multiple-year data;
- aggregation of transactions;
- definition of the arm's length range, extreme results, methods to enhance reliability, loss-making comparables; and
- documenting a search for comparables.

Public comments were invited on these draft issues notes in May 2006.

The revision of the guidance on the application of transactional profit methods followed the same procedural pattern as the project on comparability. In February 2006, the OECD invited comments on the application of transactional profit methods. Subsequently, Working Party No. 6 developed a series of draft issues notes, built on the input received and experience acquired by countries in applying transactional profit methods, which included the following issues:

- status of transactional profit methods as last resort;
- use of more than one method;
- access to information needed to apply or review the application of a transactional profit method;
- application of transactional profit methods and unique contributions;
- application of the transactional net margin method (TNMM);
- standard of comparability; application of the TNMM – selection and determination of the net profit margin indicator;
- application of transactional profit split method – determining the combined profit to be split;
- transactional profit split method – reliability of a residual analysis and a contribution analysis;
- application of a transactional profit split method: how to split the combined profit; and
- other methods.

These draft issues notes were released for public comment in January 2008.

From that point on, Working Party No. 6 took forward simultaneously the two projects, and held a consultation on both topics in November 2008 with 35 representatives from the business community and over 50 senior officials from the OECD countries and observers. On that occasion, participants put forward their concerns and recommendations but, overall, considered that the Working Party was moving in the right direction. In particular, the Business and Industry Advisory Committee to the OECD (BIAC) applauded the OECD efforts to come out with up-to-date guidance on comparability and profit methods, and highlighted the importance of consistency of approaches by governments.[3] Countries, on their side, found very valuable the direct dialogue with the business community in taking forward the project.

With the business comments in mind, the Working Party resumed its work towards a proposed revision of the relevant guidance from the OECD Transfer Pricing Guidelines. This has proven to be a challenging undertaking, as the detailed review of the relevant guidance found in Chaps. I and III has entailed not only the amendment of the existing guidance, but also the development and insertion of new guidance on certain aspects. In this exercise, Working Party No. 6 has tried to achieve a balance between a theoretically sound framework and workable guidance on application.

Therefore, the Proposed Revision of Chaps. I-III of the OECD Transfer Pricing Guidelines reflects the outcome of this work by introducing the following changes:

- *hierarchy of transfer pricing methods*. The OECD proposes removing exceptionality for the application of transactional profit methods and replacing it with a standard whereby the selected transfer pricing method should be the "most appropriate method to the circumstances of the case". In order to reflect this evolution, it is proposed to address all transfer pricing methods in a single chapter, Chap. II (Part II for traditional transaction methods, Part III for transactional profit methods);
- *comparability analysis.* The general guidance on the comparability analysis that is currently found at Chap. I of the OECD Transfer Pricing Guidelines was updated and completed with a new Chap. III containing detailed proposed guidance on comparability analyses. A new annex to this chapter provides an example of a working capital adjustment; and
- *guidance on the application of transactional profit methods*. Additional proposed guidance on the application of transactional profit methods was developed and included in Chap. II, new Part III. Additionally, two annexes have been drafted illustrating (1) the different measures of profits when applying a transactional profit split method and (2) the sensitivity of gross and net profit margin indicators.

3. The Progress Made

From a general perspective, the vast majority of commentators welcome the Proposed Revision, as it "adds more flexibility and more pragmatism to the wording of a significant number of paragraphs".[4] Moreover, private sector representatives acknowledge that the Proposed Revision "is a significant achievement, representing as it does a potential consensus between some

3. Full statement by Mr Charles Triplett at www.oecd.org/ctp/tp/cpm.
4. Comments received from CMS Bureau Francis Lefebvre.

very diverse tax authority perspectives"[5] and "shows significant improvements as compared to the 1995 document".[6]

Most notably, almost all business commentators point to the fact that the Proposed Revision clarifies the application of the OECD Transfer Pricing Guidelines, thereby enhancing the efficacy of the arm's length principle for cross-border transactions and reducing controversies between taxpayers and tax authorities as to the proper arm's length price (or results) in specific cases.

The above shows that since the beginning of the project in 2003, the OECD has been able to achieve significant progress towards consensus on many complex and potentially controversial issues, in an effort to improve the certainty of the tax environment in which the OECD Transfer Pricing Guidelines apply.

Commentators have, however, identified certain aspects of the Proposed Revision which would require further reflection and clarification from Working Party No. 6, and which are summarized below.

4. Analysis of the Comments Received on the Proposed Revision

4.1. Balancing the reliability in documenting intercompany transactions and the administrative burden on taxpayers

Documentation issues arising from the Proposed Revision drew much attention from the private sector. Several commentators question whether the Proposed Revision disproportionately increases the administrative burden on taxpayers, and note the need to balance the reliability in documenting intercompany transactions. In particular, concerns have been expressed that the Proposed Revision is perceived as setting too high a standard of comparability in the OECD Transfer Pricing Guidelines by inserting very prescriptive criteria in performing a comparability analysis despite the statement that transfer pricing "is not an exact science".[7]

In the view of one business commentator, if such a path is followed there is a risk that tax authorities may put form before substance, focusing on whether all the various steps have been strictly followed by taxpayers. According to this view, the guidance on the selection of the transfer pricing methodology and the performance of the comparability analysis should be governed by the adequacy of the transfer pricing methods to functional analyses, and facts and circumstances of the controlled transaction and the uncontrolled transactions that are regarded as potentially comparable. In the same direction, another business representative expressed the view that the guidance given to perform analyses and documentation following these principles is in many instances quite prescriptive and goes beyond providing helpful principles. In this respect, another commentator acknowledged that although the introduction of the concept of "reasonableness" is welcome, some inconsistency still arises when the standard of comparability is placed at a very demanding level in other parts of the Proposed Revision (for instance commentators pointed to the risk of having detailed guidance in performing a comparability analysis; see e.g. Para. 3.5 of the Proposed Revision).

Following the same line of reasoning, another business representative thinks that the guidance given by the Proposed Revision in performing a comparability analysis is too prescriptive and is inconsistent with the notion of "reasonableness" mentioned in several instances in the Proposed Revision. In his view, the Proposed Revision, by making use of terminology such as "reasonably reliable comparables" and "most appropriate method" without properly explaining the meaning thereof, creates ambiguity, as this could encourage tax authorities to request further documentation to meet the above criteria. The ultimate result could be an unbalanced increase of the compliance costs for the taxpayer.

This is an area that the OECD will attempt to clarify, as transfer pricing documentation requirements are a matter of best practices and of domestic law, rather than a requirement imposed by Art. 9 of the OECD Model Tax Convention on Income and on Capital (OECD Model Tax Convention)

4.2. Comparability: selected issues

The Proposed Revision updates and completes the general guidance on the comparability analysis. Given that transfer pricing is a core issue for companies and the comparability analysis constitutes its cornerstone, commentators welcome the new Chap. III dedicated to the analysis of comparability. Commentators consider that the detailed guidance on comparability analysis constitutes a well-balanced product aimed at achieving a more consistent approach by tax authorities and taxpayers.

However, the level of detail in Chap. III has raised some concerns. On the one hand, some commentators fear that the great level of detail in Chap. III may become a double-edged sword, where, as pointed out in the previous section, tax authorities adopt a form-over-substance approach.

On the other hand, commentators again reiterate that transfer pricing is not an exact science and that, in practice, it can be very difficult to meet all comparability criteria and burdensome for the taxpayer as well. Commentators stress that the new guidance on comparability should provide an indication as to what aspects should be considered when performing analy-

5. Comments from Freshfields Bruckhaus Deringer LLP.
6. It is worthwhile in this regard to report the comment received from BIAC that "commends the OECD for the excellent work done and on the general quality and approach of the Proposed Revision. In its methodological approach and in material provisions it strikes a good balance between tax administration and commercial transfer pricing practices".
7. Proposed Revision, 1.13.

ses, rather than standards that should be met. Furthermore, they emphasize that it should be applied in a pragmatic and proportional way in the context of what constitutes a reasonable effort by the taxpayer, given the facts and the circumstances of the particular case.

More specifically, commentators have identified a number of aspects that would benefit from further work and clarification, especially with regard to "reasonably reliable comparables", in order to ensure predictability and clear guidance for taxpayers. This, in turn, would contribute to avoiding the risk of unresolved double taxation.

This discussion below analyses the view of public commentators on a selected number of topics related to comparability.

4.2.1. *Role of comparability in the application of the arm's length principle*

The arm's length principle as found in Art. 9 of the OECD Model Tax Convention continues to be the standard governing the determination of transfer prices among associated enterprises in OECD countries and an increasing number of non-OECD countries.

Under the current OECD Transfer Pricing Guidelines and the Proposed Revision, the application of the arm's length principle is generally based on the comparison of the conditions (including, but not limited to, prices) made or imposed in a controlled transaction with the conditions in transactions between independent enterprises. The Proposed Revision reinforces this by clearly stating that Art. 9 of the OECD Model Tax Convention is the foundation for comparability analyses.[8]

As a counterweight to the relevance of comparability, current Para. 1.10 of the OECD Transfer Pricing Guidelines recognizes that associated enterprises may engage in transactions that independent enterprises would not undertake. The Proposed Revision elaborates from here by stating that the mere fact that a transaction may not be found between independent parties does not in itself mean that the transaction is not arm's length.[9]

The express recognition of this principle has been welcomed by many commentators, both in the context of the Proposed Revision and the OECD Discussion Draft on the Transfer Pricing Aspects of Business Restructurings (Business Restructuring Discussion Draft).[10] However, one business representative considers that, despite this addition, the comparability paradigm continues to receive an unqualified endorsement in the Proposed Revision, which may hinder the workability of the arm's length principle in practice.

While recognizing that at this stage it might not be feasible to develop a more general framework for the assessment of the arm's length nature of the "conditions" in a controlled transaction, he points out the need to recognize that comparability should not be regarded as the only paradigm.

4.2.2. *Reasonably reliable comparables*

The Proposed Revision has introduced the concept of "reasonably reliable comparables", which plays a prominent role in the methodology established in Chap. III. The new guidance on reasonably reliable comparables, which has drawn great attention from commentators, is contained mainly in new Paras. 3.2[11] and 3.3[12] of the Proposed Revision.

In this respect, business representatives generally agree with the spirit of Para. 3.2, i.e. comparability analyses should always be aimed at finding the most reliable comparables considering the circumstances of the case and the existing limitations (i.e. limitations in the availability of information and the burden related to searches for comparables data). In this exercise, the business community welcomes the explicit statement that there is not a "requirement for an exhaustive search of all possible sources of comparables", given the above-mentioned limitations.

Yet commentators have identified a number of aspects which would benefit from further consideration and clarification by the OECD, as summarized below:

The definition of "reasonably reliable comparables"

Several commentators have expressed concern with regard to this notion, which they agree would require further elaboration, especially the term "reasonable", in order to achieve higher certainty standards for taxpayers and secure a more consistent interpretation of this guidance by tax authorities.

The main criticism expressed by commentators can be summarized as follows:
– several commentators argue that the word "reasonable" is a subjective and unclear term, which

8. Proposed Revision, Para. 1.7.
9. Proposed Revision, Para. 1.11.
10. Business Restructuring Discussion Draft, Para. 27 (determination of whether the contractual terms provide for an arm's length allocation of risks) and Para. 208 (determination of whether the arrangements are commercially rational). For an analysis of the public comments received on the Business Restructuring Discussion Draft, see G. Cottani, "OECD Discussion Draft on Transfer Pricing Aspect of Business Restructurings: Summary of Business Comments and Issues for Discussion", 16 *International Transfer Pricing Journal* 4 (2009), at 231.
11. Proposed revision, Para. 3.2: "As part of the process of selecting the most appropriate transfer pricing method (see Para. 2.1) and applying it, the comparability analysis always aims at finding the most reliable comparables. This does not mean that there is a requirement for an exhaustive search of all possible sources of comparables as it is acknowledged that there are limitations in availability of information and that searches for comparables data can be burdensome. See also discussion of compliance efforts at Paras. 3.79-3.82. For this reason, the phrase "reasonably reliable comparables" is used in these Guidelines to refer to the most reliable comparables in the circumstances of the case, keeping in mind the above limitations".
12. Proposed revision, Para. 3.3: "This does not, however, imply a safe harbour. The fact that reasonable efforts have been made in finding and selecting comparables cannot rule out the possibility that more reliable comparables data may ultimately be found and used in determining an arm's length outcome".

– can create confusion and disputes in practice, as the tax authorities and the taxpayer might reach divergent conclusions as to what can be considered as "reasonable", as each is driven by different considerations; and
– some commentators find it odd that this concept, which appears in 18 paragraphs in the Proposed Revision,[13] has a meaning other than the general meaning of the notion, and disagree that "reasonably reliable" should have the same meaning as "the most reliable". If this were to be the case, the proposed definition would create "circular reasoning" which would make it virtually impossible to know whether "reasonably reliable comparables" (meaning "the most reliable comparables") have been found and used, creating an unacceptably high degree of uncertainty for taxpayers.

For one commentator, the use of the superlative "most" in "most reliable comparables" would undo much of the benefit of this guidance, given that, regardless of how inaccessible or expensive the most reliable comparables may be, there can only be one set that meets this criterion – even if it is unknown at the time. This position would expose taxpayers to accusations of negligence or failure where they may have acted entirely reasonably. As currently drafted, the absolute test required by the use of "most" is then contradicted by the immediately following sentence in the same paragraph which, as mentioned, rules out the requirement for an exhaustive search of all possible sources of comparables. Thus, the use of the word "most" is considered unnecessary, and amendments are recommended that would retain the requirement for evaluation and judgment without the suggestion that the taxpayer has failed to act properly if even better comparables should subsequently be found.

The guidance in Para. 3.3

Almost all commentators have expressed significant concerns regarding Para. 3.3, and they have strongly advocated its deletion or substantial amendment in order to ensure legal certainty for taxpayers. The main arguments expressed by business representatives against this provision are as follows:

There is tension between the guidance set forth in Para. 3.2 and Para. 3.3, which considered altogether send a contradictory message. On the one hand, Para. 3.2 imposes a requirement for the use of the most reliable comparables, yet relieving the taxpayer from the obligation of performing an exhaustive search of all possible sources of comparables, given the limitations in the availability of information and the burden derived from the search for comparables data; however, on the other hand, Para. 3.3 states that even when the taxpayer has made reasonable efforts to find and use the most reliable comparables, this would not constitute a safe harbour. Consequently, where more reliable comparables data are ultimately found and used in the determination of the arm's length outcome, an adjustment (and penalty, if any) by the tax authorities could still be possible.[14]

An outcome based on "reasonably reliable comparables" should be acceptable even if "more reliable comparables" are subsequently found where:
– the taxpayer has made reasonable efforts in finding and selecting comparables, which is substantiated with appropriate transfer pricing documentation;
– the comparables have been selected on the basis of a "reasonable" level of market research that any other company operating at arm's length would have undertaken at the time;
– the comparability analysis performed meets the five criteria set out in the Proposed Revision; and
– the outcome provides a reliable estimate of an arm's length outcome.

Finally, some commentators think that the current wording of Para. 3.3 may inadvertently validate the use of hindsight to allow tax authorities to reprice transactions based on information that the taxpayer could not reasonably have obtained nor have known at the time the transaction was entered into. Such an approach would contradict the underlying ex ante principle of attempting to replicate the behaviour by independent enterprises as set out in, for example, the first sentence of Para. 1.35 and the last sentence of Para. 3.68. For business representatives it would be very helpful to clarify that the retroactive use of new, more reliable comparables should be limited to those found to have existed at the relevant time of the transaction, so as to ensure that this conclusion is not inadvertently drawn.

The concept of "reasonable efforts" and the benefit for the taxpayer

Most commentators have raised the potential burden and legal uncertainty for taxpayers derived from the concept of "reasonable efforts". In particular, comments received point out the following issues in this regard.

The Proposed Revision does not specify how extensive the search for comparables should be in order to fulfil the requirement of "reasonable efforts". Commentators anticipate that the assessment of the reasonableness of the compliance efforts could prove to be difficult in practice. Furthermore, the yardstick for reasonable compliance efforts should in practice depend on the importance of the taxpayer, as tax authorities cannot

13. Proposed Revision, Paras. 1.13, 1.38, 1.53, 2.1, 2.3, 2.62, 2.64, 2.73, 2.86, 2.139, 2.144, 3.2, 3.29, 3.31, 3.34, 3.36, 3.37 and 3.80.
14. Commentators have pointed out that, that in addition to Para. 3.2, the guidance contained in Para. 3.3. seems to stand in contrast with the spirit of guidance in other paragraphs of the Proposed Revision, e.g. Paras. 1.13, 3.54 and 2.110 which state that transfer pricing is not an exact science and the determination of a reliable estimate of an arm's length outcome requires flexibility and the exercise of good judgment; Para. 3.37, which recognizes that "[potential comparables] will not always be perfect"; or Para. 3.80, which, as Para. 3.2, states that "there is no requirement for an exhaustive search of all possible relevant sources of information".

require from small and medium-sized enterprises what they may legitimately expect from multinational enterprises.

Almost all commentators concur on the fact that the tax authorities may not always agree with the outcome arrived at by the taxpayer, even when reasonable efforts have been undertaken to find and use the most reliable comparables, and thus a safe harbour shielding taxpayers from a primary adjustment would not be appropriate. However, business representatives believe that there should be a benefit for taxpayers that demonstrate that reasonable compliance efforts have been made to find reasonably reliable comparables, as, for instance, penalty protection or inapplicability of the rules shifting the burden of proof. Otherwise, commentators fear that taxpayers may not have any incentive to endeavour reasonable efforts.

4.2.3. Typical process

Chap. III sets out in Para. 3.5 a ten-step typical process that can be followed when performing a comparability analysis. The Proposed Revision explicitly states that such process is not compulsory, as reliability of the outcome is more important than process; and it continues to clarify that "going through the process does not provide any guarantee that the outcome will be arm's length, and not going through the process does not imply that the outcome will not be arm's length".

While commentators appreciate the more detailed guidance on this matter, the straight-forward statement on the nature of the typical process does not seem to comfort business representatives. Explicit language would be welcomed confirming that the process constitutes "good practice" rather than a standard for comparability analysis, given the risk of rigid endorsement of this process by the tax authorities, and the compliance costs and documentation burden for taxpayers, especially small and medium-sized enterprises.

According to business representatives, a more flexible approach would ensure that:
- tax authorities would not have sufficient grounds to reject the process followed by the taxpayer just because it deviates from the 10-step typical process in Para. 3.5;
- taxpayers would retain the freedom to choose, structure and support their transfer pricing policies depending on the facts and circumstances of the controlled transaction, e.g. less burdensome processes for transactions involving routine activities; and
- compliance costs and the administrative burden would not necessarily increase, given that the reliability of the outcome would be favoured over the process.

4.2.4. Information on the non-tested party

Under Para. 3.20, the application of the most appropriate transfer pricing method requires information on the comparability factors in relation to the controlled transaction under review and in particular on the functions, assets and risks of all the parties to the controlled transaction, including the foreign related party or parties. This paragraph continues to state that while one-sided methods only require examining a financial indicator or profit level indicator for one of the parties to the transaction (the tested party), some qualitative information on the comparability factors and in particular on the functional analysis of the non-tested party is also needed in order to appropriately characterize the controlled transaction and choose the most appropriate transfer pricing method.

In addition to further clarification of what is meant by "some qualitative data", several commentators argue that the application of the arm's length principle implies that tax authorities should request information from the taxpayer on foreign parties only in the following circumstances:
- where one could reasonably expect that in an arm's length situation, the domestic entity would have had access to such information when seeking to determine the outcome. According to business representatives, in an uncontrolled transaction, the parties involved may be aware of the functions undertaken by each party to the transaction. However, the level of detail available in the context of third-party transactions would not be sufficient to meet the standard set in Para. 3.20, which is otherwise expected in controlled transactions; and
- where the application of the most appropriate method requires the use of such information to determine the arm's length pricing and it is relevant to the controlled transaction.

Finally, one commentator suggests that the Proposed Revision should acknowledge that the taxpayer is not obligated to obtain foreign-based data where there are legal restrictions that would prohibit the disclosure of the foreign-based data or when where the taxpayer is not in control of the foreign party (e.g. the taxpayer owns, directly or indirectly, less than 50% of the foreign associated enterprise).

4.2.5. Information undisclosed to taxpayers

The guidance on information undisclosed to taxpayers is contained in Para. 3.35, which has raised a number of comments expressing different views with regard to the current approach.

In general, commentators appreciate the guidance in Para. 3.35, which would be in line with the recommendation for transparency set in Para. 3.4. In particular, commentators find it sound to acknowledge that the application by the tax authorities of a transfer pricing method on the basis of information available to the tax authorities as a result of the examination of other taxpayers (referred to in some of the public comments received as "secret comparables") or from sources of information that may not be disclosed to the taxpayer, would be "unfair" for taxpayers. However, differing views have been expressed on the caveat included in Para. 3.35, according to which such information could be used if "the tax administration was able, within the limits of its domestic confidentiality requirements, to disclose such data to taxpayers so that there would be an adequate opportunity for the taxpayer to defend its own position and to safeguard effective judicial control by the courts".[15]

While one commentator concurs with the position adopted by the OECD and thinks that the exception to the general rule reflects a good balance between the interest of the tax authorities and the taxpayer, several others have expressed reservations. Most commentators read the last part of Para. 3.35 as allowing the use of this information (i.e. undisclosed to taxpayers) by the tax authorities as long as it is disclosed to the taxpayer (which commentators assume would happen mainly in two contexts, namely an advanced pricing agreement and a mutual agreement procedure). Based on the premise that their interpretation is correct, the following concerns are highlighted:

– tax authorities may make a primary adjustment on the basis of information not accessible to the taxpayer at the time of either setting its transfer prices and conducting appropriate year-end compensating adjustments(under an "arm's length price-setting" approach described at Para. 3.68) or at the moment of testing its transfer prices (under an "arm's length price outcome-testing" approach described at Para. 3.69). There is a risk that the use of information undisclosed to taxpayers could lead to hindsight, as the information would be revealed after the point in time when the taxpayer still has control over the determination of its transfer prices; and
– the level of detail in the disclosure of the information may not be sufficient or proportional to the level of detail of the information to be provided by taxpayers to defend their position. Also, confidentiality issues could exist, as some tax authorities use information gathered from competitors as secret comparables. As such, the use of secret comparables could entail the disclosure of confidential information and trade secrets by companies to tax authorities in the context of a tax audit, which could be subsequently used to make a transfer pricing adjustment against a competing company.

Business representatives consider that the above potential outcomes would not be reasonable or fair for taxpayers. Furthermore, they would openly contradict the cornerstone principle in the comparability analysis that the search process should be "transparent, systematic and repeatable"; information available only to the tax authorities cannot be obtained systematically and by the taxpayer, nor is the process of obtaining that information repeatable by the taxpayer. Accordingly, most commentators would welcome stronger language clearly prohibiting the use of secret comparables by tax authorities.[16]

4.2.6. Comparability adjustments

In general, the development of new guidance on comparability adjustments has been welcomed, in particular the example of a working capital adjustment in Annex I to Chap. III. However, business commentators have pointed out certain aspects which they believe would benefit from further reflection and work.

First, it has been noted that Para. 1.35[17] and Para. 3.51[18] seem to convey contradictory messages, adding uncertainty as to when comparability adjustments need to be performed. Some business commentators believe that if a comparability adjustment to the potential comparable leads to material changes to the result, this should trigger further investigation in order to establish whether it can be regarded as a comparable to the controlled transaction.

A second point highlighted is the cautious approach to comparability adjustments that is somehow also reflected in the discussion of working capital adjustments in Paras. 3.38 and 3.52, which seems to discourage such adjustments. While business commentators recognize that there should be no presumption that comparability adjustments are always needed or will always improve comparability, they argue that the proposed guidance should acknowledge that, when properly used, comparability adjustments can:

– increase the pool of potential comparables (e.g. allow buy-sell distributors to be used as comparables to commission agents);
– allow more flexibility in the use of specific profit level indicators (e.g. by allowing income or cost-based profit level indicators to be used even when there are significant differences in assets as a percentage of sales or costs);
– improve comparability for companies using different GAAPs (by adjusting for items that are treated in different ways); and
– illustrate the impact of economic conditions on the tested party's results (e.g. by showing the impact of operating at 90% rather than 50% capacity utilization).

An additional point raised is that, according to commentators, the proposed guidance seems to prescribe that the decision to make a comparability adjustment should be based on the impact it will have in the results, which could in turn lead to arbitrariness regarding the materiality of an adjustment justifying the rejection of a comparable. Some business com-

15. Proposed Revision, Para. 3.35.
16. There is one commentator who suggests that if the current guidance is ultimately retained, penalties should not be imposed on a primary adjustment made using secret comparables, even if these are disclosed to the taxpayer.
17. Proposed revision, Para. 1.35: "Where there are differences between the situations being compared that could materially affect the comparison, comparability adjustments must be made, where possible, to improve the reliability of the comparison".
18. Proposed Revision, Para. 3.51: "Comparability adjustments do not need to be, and in fact should not be, performed to correct differences that have no material effect on the comparison".

mentators disagree with this interpretation and defend an approach based on the improvement by the comparability adjustment of the accuracy of the comparability analysis. One commentator suggests that a more stringent approach be adopted so that comparability adjustments would be performed only when a systematic deviation between controlled and comparable transactions can be identified and quantified.

Furthermore, the Proposed Revision recommends that taxpayers should document the following: the explanation of the adjustments; the reasons for performing the adjustments; how the adjustments were calculated; how the results of each comparable changed after the adjustments were performed; and how the adjustments improved comparability. Several commentators find that documentation requirements are likely to be disproportionately burdensome, considering the time and efforts needed to fulfil this compliance obligation (unless the comparability analysis does involve a material comparability adjustment and/or a specific audit).

Finally, most commentators recommend that the OECD undertake further work on adjustment techniques and the development of additional illustrations of how to make adjustments for differences such as volume or operational scale, risks or geographic market.

4.2.7. Arm's length range

The new extended guidance on the arm's length range has been well received, although commentators have again pointed out certain aspects which they believe should be further clarified and refined.

Arm's length range and the use of statistical tools

With regard to the definition of the arm's length principle, commentators have expressed their contentment regarding two issues:

- the recognition that when all observations are relatively equally reliable, the full range of comparables constitutes the arm's length range and that, in such circumstances, the use of the full range would seem appropriate;
- the endorsement of the appropriate use of statistical tools, including the interquartile range, which can "help to enhance the reliability of the analysis".

However, with regard to this latter aspect, business commentators disagree with the circumstances under which statistical tools can be used.

For some commentators, the guidance on the use of statistical tools for purposes of determining the arm's length range is rather limiting, i.e. statistical tools may be used only where it is known that comparability defects remain in the benchmark set and cannot be adjusted. They note that the use of the interquartile range has become a convention in transfer pricing, and consider that the Proposed Revision is still struggling to reflect this. The limiting interpretation in Para. 3.56 does not seem to take account of the limitations in available information and resources (e.g. time and/or budget) which may impact the ability of the taxpayer to assess whether defects remain (Paras. 5.6, 5.7 and 5.8 indicate that the taxpayer should be requested only to make a reasonableapplication of the requirement to document comparability). Finally, it is explained that in practice, the full arm's length range is often too wide to be of practical value to taxpayers in setting prices, and therefore a measure of central tendency such as the interquartile range is routinely used to narrow down the range. Commentators suggest that the above-mentioned practical reasons allowing the use of statistical tolls be acknowledged in the Proposed Revision.

Another commentator, however, points out that in some jurisdictions measures of central tendency, such as an interquartile range, can be overused and do not always appear to enhance reliability (e.g. the interquartile range might not correct material operational differences between the benchmarks and the tested party or transactions). This commentator notes that the interquartile range narrows the range of the financial results of a group of allegedly reliable comparables by eliminating the comparables that are "outliers" in terms of their financial results. However, one could wonder whether the outlying financial results have necessarily any connection with the qualitative, substantive or operational differences at issue. Where the interquartile range narrows the range of financial results, leaving out loss companies and excluding companies with relatively high profits, the statement in the Proposed Revision which reads "it is the facts and circumstances surrounding the company in question that should determine its status as a comparable, not its financial result" might not be met, as those observations excluded may in fact be from the companies that are most comparable to the tested party or transactions. Hence, some guidance would be welcomed illustrating that statistical tools do not necessarily enhance the reliability of the results and should not be a substitute for selecting the right type of comparable or making adjustments for material differences where possible.

Finally, a third point raised by another commentator is that the use of an interquartile range should be driven by the results of the search for comparables. For instance, if the range of results is narrow, the interquartile range has little or no value because a narrow range is indicative of the robustness of the results. On the other hand, if the range of results is wide, provided that the taxpayer applied the most appropriate method and followed the ten-step process in performing a comparability analysis, the interquartile range can be a useful tool to obtain the central tendency of the results. This business representative believes that the current wording of Para. 3.56 does not provide sufficient guidance on the application of statistical tools, and asks the OECD to provide additional guidance, including examples, on the proper use of statistical tools.

Statistical tools and the selection of the most appropriate point in the range

The strongest criticism of the guidance on the selection of the most appropriate point in the range lies in the use of statistical tools for such purpose where the arm's length range still contains comparability defects. While some commentators would support amendments to the proposed guidance, most of them would favour deletion of Para. 3.61.

The main argument against this approach is that it could contravene the arm's length principle. The comments received wonder why measures of central tendency should be more appropriate than any other point in the range, and fear that the use of simple or weighted averages, the median or the most frequent value (mode) within the range are likely to produce arbitrary results. Furthermore, this provision could be interpreted by tax authorities as supporting routine adjustments to the median, for instance, rather than to another point in the range (upper or lower end of the range). They argue this would be highly negative for the business community and contradictory to the principles established in the current OECD Transfer Pricing Guidelines.

One commentator adds that this approach (e.g. adjustments to measures of central tendency) should not be used as a tool to ensure compliance by making non-compliance less advantageous for the taxpayer, as this should be addressed by an appropriate domestic system of penalties, rather than through arbitrary adjustments.

In view of this, several commentators claim that if an agreement can be reached on what the range should be (e.g. an interquartile range), there is no reason to depart from the practical solution that consists in referring to either the lowest or the highest point of such range where the reported results are outside such range or to a statistical deviation when there are substantial concerns about the validity of the edge of the range. In any event, the point of the range selected should be the one that better reflects the facts and circumstances of the taxpayer.

A second point raised is the unclear meaning of what constitutes the "central tendency", together with the lack of a consensus approach as to the selection of the most appropriate point in the range. Business commentators are concerned that tax authorities may implement the guidance differently, not only on what constitutes the arm's length range, but also on the measure of central tendency to which to make the adjustment. In fact, business commentators have already encountered this problem, and regret that the Proposed Revision does not address this satisfactorily, given the significant adverse effects it may have in eliminating double taxation.

4.3. Selection of the most appropriate transfer pricing method to the circumstances of the case

A major area of concern from the private sector stems from the notion of the "most appropriate transfer pricing method to the circumstances of the case". The majority of commentators welcome the elimination of the last resort status for transactional profit methods. However, they express concerns with the way the "most appropriate method" standard is expressed in Paras. 2.1-2.9 of the Proposed Revision.

According to Para. 2.1 of the Proposed Revision, there are four driving criteria for the selection of the most appropriate transfer pricing method to the circumstances of the case by the taxpayer:

- a consideration of the respective strengths and weaknesses of each of the OECD transfer pricing methods;
- the appropriateness of the method in view of the nature of the controlled transaction, determined in particular through a functional analysis;
- the availability of reasonably reliable information (in particular on uncontrolled comparables) to apply the selected method or other methods; and
- the degree of comparability, including the reliability of any comparability adjustments needed.

The OECD considers that by retaining a hierarchy among the various transfer pricing methods, certainty for taxpayers is enhanced, as the four criteria in Para. 2.1 would contribute to guide the selection of the most appropriate method.

Business representatives, however, perceive the "most appropriate method" standard as a provision resembling the "best method" rule whereby all methods must be tested and their rejection justified.[19] In this respect, some commentators urge the OECD to clarify that once a taxpayer has made reasonable efforts to select an appropriate transfer pricing method, tax authorities should not replace it with another method, unless the taxpayer's selected method is in fact not appropriate.

Ultimately, the preference expressed by commentators would be to replace the "most appropriate method" standard with an "appropriate method" standard that would remove the ambiguity in the selection (and documentation) of the transfer pricing method. Following this line of reasoning, two commentators think that the statements contained in Paras. 2.1. and 2.7 of the Proposed Revision recording that "the applicability of any particular method needs not be disproved" and that not "all the transfer pricing methods should be analysed in depth or tested in each case" are contradicted by reference to "*the* most appropriate method" and to "*the* best estimation of an arm's length price".

In their view, should the wording of these paragraphs be left unchanged, the clarification purportedly achieved by removing the previous hierarchy amongst traditional and profit-based methods would lose its

19. See e.g. US Treas. Reg. Sec.1.482-1(c)(1).

significance, as factually the taxpayer would be induced to demonstrate that all methods not selected are inappropriate, rather than limiting itself to showing the appropriateness of the one method that is selected.

According to commentators, another potential source of misunderstanding between taxpayers and tax authorities would be the wording in Para. 2.2. of the Proposed Revision, where it is stated that in the event a traditional transaction method and a transactional profit method can be applied "in an equally reliable manner", the traditional transaction method is preferable to the transactional profit method. A number of business representatives pointed at the circumstance that the Proposed Revision could lead to protracted disputes over the selection of methodology where tax authorities determine "equal reliability" in order to force the use of a traditional method.

Another commentator expresses the view that reference to "an equally reliable manner" raises doubts as to whether the taxpayer has the duty or the possibility to test the possible application of transactional profit methods in cases where a traditional transactional method may be applied in a reliable manner. Interestingly, another business representative suggests avoiding any hierarchy (as provided for by Para. 2.2. of the Proposed Revision) in selecting "the most appropriate" transfer pricing method, as currently there is no valid criterion to measure the appropriateness of each and every transfer pricing method to the circumstances of the case.

4.4. Application of the transactional profit method: does the Proposed Revision encourage a broader use of profit-based methods?

A number of commentators note that the Proposed Revision unfortunately (and perhaps unintentionally) leaves too much room for an inappropriate use of the profit split method. In this regard, one commentator highlights that the wording chosen in certain paragraphs of the Proposed Revision (e.g. Paras. 1.36.-1.62 regarding transactions that may not be comparable, or Paras. 2.101-2.117 and Paras. 2.143-2.144) is biased towards granting more authority to tax authorities to find fault with the use of other recognized OECD methods other than the profit split method.

In supporting the above-mentioned view, another business representative refers to some scenarios encountered in real-life cases where a profit-based method has been applied to support substantial adjustments, where instead an available comparable uncontrolled price method analysis would have yielded a reliable arm's length adjustment. Further, other commentators observe that given the level of detail provided and the wording used in explaining the technicalities of the transactional profit-split method and of the TNMM, the OECD should confirm that within the transactional profit-based methods there is no difference in hierarchy among the profit split and the TNMM method.[20]

The question of whether with the Proposed Revision the OECD wishes to encourage a broader use of the profit split method has been already considered in the past. Working Party No. 6 delegates indicated that this was not the intention. However, the OECD will try to clarify that the Proposed Revision does not aim to encourage a broader use of the profit split method.

5. How to Split the Combined Profit

Some commentators believe the Proposed Revision should put more emphasis not only on allocation keys based on assets or costs, but also on those relying on the functions performed and the risks borne by each entity. These comments are justified by the argument that functions and risks are the cornerstone of any functional analysis and should not be ignored in the framework of the application of a transactional profit split method.

Another business representative expresses the view that the Proposed Revision favours a simple application of the profit split analysis based on transparent data. However, that commentator argues that such an approach may be difficult to apply in the context of highly integrated business processes that have in place more refined and sophisticated approaches of determining the value and relative contribution of each entity to the company's value chain.

6. Conclusion

From the outset of the projects on comparability and transactional profit methods, the OECD has held a proactive and constructive dialogue with the business community in order to achieve the development of clear, consistent and administrable transfer pricing provisions.

The comprehensive comments received from business and non-governmental stakeholders highlight the interest and relevance of the Proposed Revision. While some areas for further work by the OECD have been identified, commentators have stressed the excellent work done by the OECD and the general quality and approach of the Proposed Revision, which has achieved a good balance between tax authorities and commercial transfer pricing practices. This reflects the substantial progress achieved since the project began in 2003.

In the coming months, it is expected that Working Party No. 6 will discuss the comments received and finalize the proposed new guidance, with a view towards publishing the finalized version before the end of 2010.

20. The same commentator points out that in various paragraphs, the Proposed Revision seems to place the profit split method ahead of the TNMM, and that the latter should be corroborated with a profit split analysis (e.g. see Para. 2.108 of the Proposed Revision).

