



Revised OECD transfer pricing guidelines respond to business concerns on key issues

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The OECD recently released a proposed revision of chapters I-III of the Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations. The proposed changes represent a key step in implementing OECD projects on comparability and transactional profit methods, two areas considered a priority by the OECD Committee on Fiscal Affairs.

In particular, the proposed revision reflects the outcome of extensive consultation by the OECD with the business community around the May 2006 discussion draft on the theoretical foundations of comparability analysis and the January 2008 discussion draft on the transactional profit methods. Given that the existing guidance on these aspects dates back to 1995, the proposed update represents an effort by the OECD to align the principles laid out in the Transfer Pricing Guidelines with the practical considerations of tax administrations and the business community.

This important OECD update focuses on the hierarchy of transfer pricing methods, comparability analysis, and application of the transactional profit methods.

Comments on the revision are due to the OECD by January 9, 2010. For a link to the proposed revision of Chapter I-III of the Transfer Pricing Guidelines, please click here:

http://www.oecd.org/document/26/0,3343,en_2649_33753_43656346_1_1_37427,00.html

Hierarchy of Transfer Pricing Methods

A major aspect of the existing guidance is the hierarchy between the traditional transaction methods, which were considered preferred methods, and the transactional profit methods, which were considered methods of last resort. According to the proposed revision, all the methods would be on the same footing, and the method selection judgment should be made on the basis of the "most appropriate method to the circumstances of the case."

The use of “other methods” -- those not described in the Guidelines -- would have to be supported by documentation, including an explanation of why OECD-recognized methods were not appropriate or not workable.

Observations. This is an important development because, from a pragmatic point of view, more often than not the data available under the specific circumstances of each case would warrant application of a transactional profit method -- such as the transactional net margin method, which is similar in application to the comparable profits method of the U.S. transfer pricing regulations -- rather than a traditional transactional method.

The proposed revision would provide reassurance that the "most appropriate method" standard does not mean taxpayers need to analyze or test every other method in depth -- a concern raised by PricewaterhouseCoopers ("PwC") during the consultation phase -- but there may still be concerns that the proposed standard would be too close to “best method.”

The revision also provides explicit reassurance that the use of a secondary (corroborative) method is not compulsory. This potentially addresses concerns raised by PwC during consultation that a secondary method might become expected by tax authorities.

Comparability Analysis

The guidance on the comparability analysis currently in Part C of chapter I of the Transfer Pricing Guidelines was updated and supplemented with a new chapter III on comparability.

Among other changes, the proposed guidance lays out a 10-step process for performing a comparability analysis. This analysis is recommended as a "good practice," but would not be compulsory -- that is, the reliability of the outcome is more important than the process.

Specifically, the guidance would provide that internal comparables "may have a more direct and closer relationship to the transaction under

review than external ones." While recognizing that internal comparables "are not always more reliable," the proposed guidance recognizes that obtaining information on internal comparables likely would be less costly than obtaining information on external comparables.

The proposed guidance further indicates that non-domestic comparables might be acceptable, but the systematic use of regional searches for comparables is not specifically endorsed. Further, loss makers and extreme results in general, like non-domestic comparables, should not be automatically excluded -- a case-by-case assessment is needed.

The draft also suggests that one should not only look at the tested party in case a one-sided approach is selected (e.g., cost plus, resale price, or transactional net margin methods), but also should gather qualitative information on the functional analysis of the non-tested party. The draft recognizes that the choice of tested party can be driven by the appropriateness of the methodology and the availability of data.

Further, the proposed revision includes guidance on the selection or rejection of comparables based on the "additive" and "deductive" approach (i.e., internal sector/industry knowledge vs. broad database search).

Observations

The proposed revision includes a helpful expanded discussion on consideration of comparability and the five comparability factors.

The proposed revision also provides a useful acknowledgment that because some factors are likely to be less important than others, the non-comparability of some factors does not preclude an overall conclusion of "reasonable comparability."

Regarding whether the relative lack of accuracy of the functional analysis of external comparables might be counterbalanced by the size of the third-party data sample, the draft warns that quantity does not

make up for poor quality of data in producing a reasonably reliable analysis.

As to the timing of collection of data, the proposed revision notes that independent parties would not base pricing decisions on past information alone but also would take account of market expectations.

Application of the Transactional Profit Methods

Chapter II now includes a new Part III with additional guidance on application of the transactional profit methods, including additional guidance on the application of the profit split method and on the comparability standard to be applied to the transactional net margin method("TNMM").

In applying the profit split method, the proposed revision would:

- Highlight the need for a common basis regarding accounting practices and currency when determining the profit to be split among the parties to a transaction;
- Recognize that several allocation keys for splitting the combined profit are applicable, including asset-based, capital-based, and cost-based allocation keys, emphasizing that the choice of allocation key depends on the facts and circumstances of the case and should be "reasonably independent of transfer pricing policy formulation" and be "supported by reasonably reliable comparables data"; and
- Specify that the splitting factors should be applied "consistently over the life-time of the arrangement, including during loss years."

It also appears that the application of the TNMM would be made more onerous due to:

- Rigorous definitions of "net profit" for comparability purposes;
- Rigorous profit level indicator selection and support; and
- Strong focus on functional analysis necessitating the collection of qualitative information on both the tested and non-tested parties.

The proposed revision also addresses the issues concerning the need

for capital adjustments and would provide practical formulae for performing these adjustments in an appendix.

Observation

The discussion on “reasonably reliable comparables” -- that the balance of burden and costs should be based on pragmatic risk assessment -- while helpful, does not imply a safe harbor.

Some observers believe that one consequence of the new revised guidelines would be to permit tax authorities to place greater reliance on profit split transfer pricing methods. This conclusion results from the increased status of profits-based methods in general under the revised guidelines, and the more stringent comparability requirements applied under a TNMM. The result may be to make it impossible to qualify a TNMM analysis on comparability grounds, and to therefore make profit split analyses the method of last resort. If the proposals have this effect, they could be quite detrimental to transfer pricing positions taken by many taxpayers.

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