Tax Representation

ICAEW TAX FACULTY

TAXREP 13/07

HIGH LEVEL COMMENTS ON OECD CONSULTATIONS ON TRANSFER PRICING ISSUES AND IN PARTICULAR COMPARABILITY ISSUES AND THE APPLICATION OF TRANSACTIONAL PROFIT METHODS

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INTRODUCTION

1. Jeffrey Owens, Head of Tax at the OECD Centre for Tax Policy and Administration (CTPA), attended a meeting at ICAEW Chartered Accountants' Hall in London on 7 February 2007 to address an invited audience of international tax aspects convened by ICAEW Tax Faculty. Details about the ICAEW Tax Faculty are given at Appendix 1.

2. A report of the meeting is reproduced at Appendix 2. This first appeared in the March issue of *TAXline.*

3. In advance of the meeting Tax Faculty submitted a paper to OECD setting out some high level comments on recent consultations on priority areas identified in relation to the 1995 Transfer Pricing Guidelines. The paper is reproduced below, paragraphs 7 to 19. The paper was drafted by John Neighbour, a member of the Tax Faculty Large Business and International Tax Committee and a partner at KPMG and formerly head of OECD's Tax Treaty, Transfer Pricing and Financial Transactions Division.

4. The two priority areas identified by OECD are:

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

5. On 27 February 2006 OECD released an open invitation to comment on a number of issues in relation to transactional profit methods described in the OECD's Transfer Pricing Guidelines for which the deadline for responses was 31 August 2006. The sixteen responses to this invitation are published on the OECD website at http://www.oecd.org/document/8/0,2340,en_2649_33753_37422280_1_1_1_1,00.html

6. On 10 May 2006 OECD published a series of issues notes on comparability that was developed by the Committee on Fiscal Affairs' 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 an open questionnaire released in 2003. Comments were requested by 30 November 2006. Thirteen responses were received and are also published on the OECD website at http://www.oecd.org/document/32/0,2340,en_2649_33753_37833824_1_1_1_1,00.html

DETAILED COMMENTS BY ICAEW TAX FACULTY

OECD consultation on comparability issues

7. We commend the OECD for its recent initiatives to provide greater guidance for both taxpayers and tax administrations in the areas of comparability and profit methods. The OECD Transfer Pricing Guidelines remain at a conceptual level the

internationally accepted “rules of the game” but we urge the OECD to continue to improve the practical application of the Guidelines to modern business both by providing flexible, pragmatic and non-prescriptive guidance and by encouraging tax administrations to follow the Guidelines in tax audits in a flexible and pragmatic way.

8. We note that a number of detailed comments have been submitted in respect of the consultation on comparability. Whilst in general we endorse the comments from other business and professional associations, we thought it worthwhile to set out some high level principles to assist the OECD in ensuring its initiatives are successful.

Respecting the transaction as made by the taxpayer

9. We are concerned that the comparability exercise does not lose sight of the fact that the starting point for any transfer pricing analysis is the transaction as entered into by the taxpayer and that the comparability analysis should ensure that a comparison is made with similar transactions. We are worried that a number of tax authorities start by re-characterising the taxpayer’s transaction into an alternative transaction and then performing the comparability analysis in respect of that alternative transaction.

10. Accordingly, we believe that tax authorities should respect the contractual terms that related companies have entered into if these are commercially rational and if they are followed in substance when the transactions are carried out. The contractual terms demonstrate to the tax authorities what were the intentions of the related parties at the outset and an alternative analysis based on what the tax authority thinks would have happened should not be substituted for the actual terms. Even if the tax authorities decide that they wish to make a transfer pricing adjustment, they should not, absent the two situations provided for by 1.37 of the OECD Guidelines, in general change the nature of the transaction as drawn up in the contract. Nor should tax authorities simply apply profit split methods where traditional methods can be applied, as profit methods, unless applied very carefully, also have the effect of ignoring the actual transaction entered into by the tax payer, in particular by ignoring contractual arrangements leading to the location of risk and capital. In short, the OECD should in its work on comparability analysis reiterate that:

    - The starting point for comparability is the transaction as actually entered into by the tax payer;
    - Tax authorities should only disregard the actual transaction entered into by the tax payer in the two circumstances set out in paragraph 1.37 of the OECD Guidelines;
    - Suitable adjustments could be applied to comparable transactions between unrelated parties rather than the transaction between related parties being re-characterised in order to make it fit with a tax authority’s view of what the transaction should have been; and
    - Profit split methods should not be applied by tax authorities in such a manner so as to effectively override the contractual terms of the transactions entered into by the taxpayer.

Compliance burden and documentation requirements

11. Multinational groups are concerned about the compliance costs that can result from the differing transfer pricing requirements in various countries and inconsistencies between the rules. The group must always do a balancing exercise so as to provide adequate data to the various tax authorities while keeping compliance costs within a reasonable limit. Documentation requirements should therefore not place an unnecessary compliance burden on the taxpayer and should reflect the transfer pricing risks actually involved. Chapter V of the OECD Guidelines and the prudent business management principle provide excellent and adequate guidance and we are concerned that many tax authorities seem to be adding more and more complexity to these basic principles by providing shopping lists of information much of which may be irrelevant to the transfer pricing risks involved and the tax payer in question. In short, the OECD should in its work on comparability analysis reiterate that:

    - Tax administrations should not ask at the outset for information that may not be relevant to their enquiry and should make a risk assessment before requesting information to ensure that it is commensurate with the risks involved (e.g. by focusing on the 20% of transactions that give rise to 80% of the profit)
    - If the tax administration requires further information to complete the enquiry they can always ask for this at a later date when their demands for information can be more focused;
    - The tax administration should inform the taxpayer of why that particular information is relevant to the enquiry;
    - The taxpayer should have a chance to say why the information requested is not relevant and to point out the extra cost involved in retrieving the information;
    - Documentation based on the prudent business management principle should be sufficient; and
    - The result of such a process would be more cooperation from the taxpayer.

Different standard for setting prices as opposed to testing prices

12. Tax authorities should accept the reality of the price-setting process within the company and should respect the method used by the taxpayer in setting prices in the first place provided this reflects business reality. The initial task of setting prices should not be made more burdensome by the necessity to demonstrate to the tax authorities that the prices have been set at arms length.

13. Some taxpayers want to use detailed transfer pricing methodologies or bargains based on business tensions to actually set prices as they want to be able to measure business units' performances on an arm's length basis. They should be free to do so and indeed where this leads directly into the incentives of the personnel of the business units this should be recognised as providing powerful evidence that the prices are arm's length without the need for detailed comparability studies.

14. In such cases, the taxpayer should be able to use a simple method to provide a sanity check on the arms length prices, for example a transactional profit method, when filing the tax return. In other cases, the taxpayer may not wish to consider transfer pricing when setting prices and should be free to do so, although the taxpayer would then be expected to provide more detailed transfer pricing analysis when filing the tax return. In short, the OECD should in its work on comparability analysis stress that

    - Taxpayers should use the methods to set prices that are the most convenient from a practical point of view
    - The tax authorities should have respect for the taxpayer's own price-setting methods, as the taxpayer has specialist knowledge of its own industry and will have more awareness of the competitors, especially where the performance of the various business units and the incentives of the staff are measured on a post-transfer pricing basis.
    - Any lack of information on how prices were originally set should not necessarily lead tax authorities to conclude that the prices were not at arms length
    - The use of the specified methods to set prices might lead to an unnecessary administrative burden on the taxpayer
    - Any requirement to use the specified methods in price setting could undermine the ability of the enterprise to set the prices with specific management objectives in mind
    - A different method could be used in subsequent testing of prices, for example a transactional profit method, when filing the tax return

The comparable uncontrolled price (CUP) should be used with reasonable adjustments where possible

15. The OECD transfer pricing Guidelines (paragraph 2.7) state that the CUP method can be used where:

    > "1. none of the differences (if any) between the transactions being compared or between the enterprises undertaking those transactions could materially affect the price in the open market or 2. reasonably accurate adjustments can be made to eliminate the material effects of such differences".

16. Sometimes, not enough effort is made by tax authorities to look for the adjustments that could be made to a CUP, and instead the CUP is rejected as the comparables are seen as being insufficiently accurate. However, a transactional profit method is then often used, where the standard of comparability is much lower than that required for the CUP method. Instead, in many cases a more thorough search could be made for comparables that would be usable with reasonably accurate adjustments. Further, where the taxpayer has internal CUPs, every effort should be made to make reasonably accurate adjustments for any differences as opposed to simple rejection. In short, the OECD should in its work on comparability analysis stress that

    - Internal CUPs could often be used, with the appropriate adjustments, rather than being rejected because they are not identical

- An imperfect CUP may still be more accurate than use of a transactional profit method and so the taxpayer's CUP should not simply be rejected because of the need to make adjustments

Recognition of data publicly available

17. The tax authorities should take a practical view of the data that is publicly available and should recognise that transactions between related companies take a variety of forms that require a flexible approach by the tax authorities when applying the Guidelines. The Guidelines represent an aspiration rather than a rigid rule which must be applied in every situation. A flexibility of approach is built into the Guidelines and this should be emphasised in the Guidelines themselves. The availability of comparables in the public domain which can be used to defend the company's transfer pricing may require an approach that is less than perfect. Making complex adjustments, eg capital intensity adjustments, to imperfect data doesn't do anything to improve the reliability of that data. By contrast, statistical methods such as the use of inter-quartile range do improve the quality of imperfect data by removing outliers. Tax authorities should accept this reality. In short, the OECD should in its work on comparability analysis stress that

    - The availability of comparables in the public domain which can be used to defend the company's transfer pricing may require an approach that is less than perfect
    - Where data is imperfect, the imperfections are rarely solved by making complicated adjustments to account for perceived differences
    - The use of statistical methods, such as the inter-quartile range, should be permitted as, when applied carefully, they can improve the quality of imperfect data

The authorities should not default to the use of profit split methods

18. Profit split methods are of considerable practical importance as international business becomes more integrated. However, there is a danger that profit split methods are used by tax authorities just to apportion profits without any underpinning transfer pricing analysis of functions, assets and risks and the relative contribution of the parties to the earning of profit. To avoid over-rewarding relatively routine functions, we feel that the residual profit analysis should be preferred over the contribution analysis.

19. As noted earlier, the tax authority should start from the analysis made by the taxpayer and respect this analysis. For example, where the taxpayer's functional analysis shows that a particular related party is a distributor and a specified transfer pricing method is used, the tax authority should not attempt to impose another method such as a profit split method, which may have the effect of attributing to the distributor profits relating to risks and assets that are held elsewhere in other group companies. In short, the OECD should in its work on comparability analysis stress that:

    - Profit split methods should not be used by the tax authorities only because they are easier to use or result in a larger transfer pricing adjustment;

- The profit split method is useful in some cases but should only be applied where appropriate; and
- Where a profit split is used, a residual rather than contribution analysis method should be used to allocate profit as this will lead to a more accurate allocation of profit in terms of the risks, assets and functions of the related parties

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APPENDIX 1

WHO WE ARE

1. The Institute of Chartered Accountants in England and Wales ('ICAEW') is the largest accountancy body in Europe, with more than 128,000 members. Three thousand new members qualify each year. The prestigious qualifications offered by the Institute are recognised around the world and allow members to call themselves Chartered Accountants and to use the designatory letters ACA or FCA.

2. The Institute operates under a Royal Charter, working in the public interest. It is regulated by the Department of Trade and Industry through the Accountancy Foundation. Its primary objectives are to educate and train Chartered Accountants, to maintain high standards for professional conduct among members, to provide services to its members and students, and to advance the theory and practice of accountancy, including taxation.

3. The Tax Faculty is the focus for tax within the Institute. It is responsible for tax representations on behalf of the Institute.

APPENDIX 2

Creating peaceful co-existence in the tax world – the role of OECD

Jeffrey Owens, Head of Tax at the OECD Centre for Tax Policy and Administration (CTPA), came to Chartered Accountants' Hall on Wednesday 7 February 2007 to speak to an invited audience of international tax experts convened by the ICAEW Tax Faculty.

The CTPA is the forum for the 30 Member countries of OECD which work together and agree the ground rules by reference to which multinational companies and international trade are taxed by the Member Countries. The Committee on Fiscal Affairs is the main policy group of the OECD. In addition to the 30 Member countries six countries have Observer status and these are: China, Argentina, Chile, India, South Africa and Russia.

The OECD publishes and regularly updates its Model Double Tax Convention which is the basis for more than 2,500 bilateral Double Tax Agreements (DTA). The UK has entered into more than 100 DTAs with the countries with which UK companies trade and do business. In addition the OECD published its transfer pricing guidelines in 1995, which are regularly updated, and which contain its arm's length principle to determine the 'correct' level of individual country profits when groups of companies trade across the globe. Well over 50 per cent of world trade is between groups and associated companies so the importance of these transfer pricing guidelines cannot be overestimated.

And not least the OECD aims to provide the frameworks which Member Countries can put in place so that the inevitable disputes can be resolved – hence the title of Jeffrey's presentation.

On the very day of Jeffrey's visit to London the OECD published a report on an arbitration procedure to be incorporated into future DTAs to provide a foolproof mechanism to resolve disputes between taxpayers and tax administrations that remain unresolved after more than two years. For some time there has been a Mutual Agreement Procedure but this has not always proved sufficient to settle the most intractable disputes.

Consensus or the rule of the majority

The OECD has traditionally operated by consensus so that any proposals have to be agreed by all the Member Countries. There is the possibility of veto but this has been used on only one or two occasions in the 45 years of the OECD's existence. Jeffrey wondered aloud about the desirability of thinking about modifying this approach in the future so that Member Countries could have the possibility to make explicit those issues, for instance in the Transfer Pricing Guidelines, where they were going to deviate from the consensus. The major issues would still have to be agreed by consensus but there might be some, signposted, variance at the margin which would be announced upfront by the Member Country concerned. This could create greater certainty for business which would know when a particular country took a different view to a particular part of the Guidelines.

Jeffrey pointed out that the EU has recently been treading a similar path by issuing Communications which encourage the EU Member States to act in a particular way but are not prescriptive in the way of the EU Directives which have been the standard approach in the past by the EU Commission. Jeffrey made it clear that the possibility of the Transfer Pricing Guidelines no longer being consensual was not yet even under discussion at OECD but he wanted to use the current meeting to gauge the reaction of business and advisers to this possible change in direction.

Enlargement of the OECD

There have been 30 Member Countries of OECD for a long time and these represent in the main the industrialised countries at the beginning of the 1960s with the exception of Russia, as it currently is, as the Cold War was in full swing in 1960 and USSR was not invited to join OECD. The present situation is completely different and OECD is about to launch discussions with Brazil, Russia, India, China and South Africa, the so-called BRICS countries, with a view to admitting these countries to membership or at least enhancing the engagement with them. It is anticipated that most of these countries will have become members of OECD within the next ten years.

It has just been announced that India's outward investment was greater than inward investment into that country in 2006 which shows how integrated these, non OECD, countries are becoming in the world economy. The size and growth rates of their domestic economies has already received an enormous amount of international publicity but their inter-connectedness with the other world economies makes their engagement with OECD even more important if OECD is to continue to play a pivotal role on the world scene since this may enable the OECD to influence the way they deal with international business issues to reflect both the interests of international business as well as the interests of the country itself.

If these countries are within OECD it may be possible to influence the way they deal with international business issues to reflect both the interests of international business as well as the interests of the country itself.

The Transfer Pricing Guidelines

Jeffrey felt that the arm's length principle remains the gold standard for determining the appropriate level of individual country profit when trading takes place within international groups of companies as it aims to parallel what happens in the real, independent, world.

Jeffrey noted that the European Union was moving in a different direction with the Common Consolidated Corporate Tax Base (CCCTB) under which a profit would be determined for the group of companies. This profit would then be apportioned to the individual companies in accordance with a formula which has yet to be determined. Jeffrey felt that this might undermine the 'arms length principle' as the world-wide standard and that it would be administratively burdensome for companies which could find themselves having to keep 2 or even 3 sets of accounts. There were also at least 15 technical issues which remained to be resolved.

One other issue which has been aired in recent OECD consultations is whether profit based methods should have a more prominent role in determining transfer prices than was felt appropriate when the guidelines were agreed in 1995. The Tax Faculty presented some 'high level' comments to OECD just prior to the meeting which are published in the body of this document.

The OECD Model Double Tax Convention

As noted above this has formed the basis for more than 2,500 bilateral DTAs but making changes to the Convention is very cumbersome and can take more than 5 years from the time that a particular problem is identified. Even when the Convention is changed it may take 10-15 years before that change is reflected in individual DTAs.

One radical suggestion has been put forward, by John Avery-Jones and Philip Baker, the latter of whom was at the ICAEW meeting, which is to have a Multilateral Framework under which there could be bilateral protocols so that the whole process of renegotiation would be very considerably speeded up from the present very cumbersome arrangements.

Jeffrey also floated some ideas to create a better understanding of the nature of DTAs and international tax law and a keener appreciation as to how the Commentary fits into the overall picture. Not least it might help if everyone in the system, and that would include Judges, had a better grounding in these issues than perhaps they always do at the present time.

Business Restructuring

Tax administrations are concerned that large multinational corporations can restructure their businesses and consolidate different parts of their global operations in such a way that the most profitable elements, often related to intellectual property and intangibles, end up in low tax jurisdictions and erode the tax base of OECD Member Countries.

Business is trying to maximise synergies and economies of scale, streamline management of business lines and improve the efficiency of the supply chain and governments are at the moment reacting in an uncoordinated way to this threat to their tax base. Hence the OECD has established a project to look at the relevant issues and has established a Joint Working Group as well as a Business Advisory Group which met twice in 2006 to ensure that the issues are properly articulated and better understood.

At the moment the proposal is to publish a Consultation Document in the second half of 2008 but Jeffrey will be trying to see if the timetable can be brought forward as these issues need to be addressed more urgently than that.

Resolving International Tax Disputes

On the very morning of the meeting OECD published a report aimed at introducing a procedure to be incorporated into Article 25 of DTAs to provide for mandatory arbitration if transfer pricing disputes remain unresolved, under the Mutual Agreement Procedure, after 2 years. See http://www.oecd.org/ctp/memap

Attribution of profits to Permanent Establishments

OECD has now published the final versions of papers 1 to 3 covering general issues, global trading and financial institutions. Jeffrey said that he hoped the revised Commentary to the existing Article 7 would be published around April, and the new version of Article 7 plus Commentary would be issued before the end of the year.

Forum of Tax Administration.

This was created in late 2002 and brings together the Commissioners of 40 plus Tax Administrations. It has met three times, most recently in September 2006 in Seoul where it issued its Seoul Declaration. At the time some commentators felt the Declaration was overly aggressive, particularly in relation to the role of tax intermediaries, but the terms of reference of the tax intermediaries' project, published in January 2007, are more measured. (http://www.oecd.org/document/50/0,2340,en_2649_33749_37930802_1_1_1_1,00.html) The tax intermediaries' project is being jointly managed by HMRC and the OECD secretariat. It is intended to help set out the 'rules of engagement' between taxpayers and tax administrations so that they can develop relationships which benefit both tax administrations, tax intermediaries and taxpayers – a potential win-win-win situation.

The Forum has recently explored a number of topics on taxpayer services. These include promoting a codification of taxpayers' rights and establishing service standards; a report on this was published in October 2003. Other topics have included: compliance risk management techniques; use of modern technology to support taxpayer service delivery; use of partially pre-filled tax returns; the take-up of electronic services; and a comparative information series of publications on aspects of tax administration in some 45 countries.

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