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A Transfer Pricing
Publication

Pricing Knowledge Network

Focusing on the impact of major intercompany pricing issues

OECD publishes revised guidelines on transfer pricing

The OECD has now approved the proposed revisions to Chapters I-III of the Transfer Pricing Guidelines for Multinational Enterprises and Tax Authorities. The revised text results in major changes to the OECD's authorised approach which will have a significant impact on the application of transfer pricing analysis in much of the world. In addition, the OECD has simultaneously published a new chapter IX to the Transfer Pricing Guidelines related to business restructuring. This new addition to the Guidelines is based on earlier issues notes on the subject and is addressed separately in another PKN.

The revisions to Chapters I-III are the result of several years of work on comparability in general and the use of profit based methods in particular. Consequently the significant changes are broadly as expected, but there are some developments on more detailed points that have arisen over the last few months.

No effective date has been expressed for these changes and consequently PwC expects that many countries will begin applying the principles set out in the revised text of the Guidelines immediately. Where this is to their advantage, some tax authorities may seek to apply them to tax disputes arising in earlier years.

Further details are provided below but, in summary, taxpayers should expect to see increased challenges on the comparability of data used to support the application of one-sided methods (TNMM, resale price and cost plus), more focus on intangibles, additional pressure to use or, at least, to consider profit split and closer examination of the processes followed to establish or document their transfer prices.

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The impact of the changes is also likely to be felt in planning and implementation of transfer pricing policies as treatment of these aspects is now addressed specifically for the first time. The revised text places considerably more emphasis on the processes adopted by taxpayers, the reliability of those processes in applying the arm's length principle and the quality of the analysis that supports them.

Summary of Changes to Chapters I - III

The OECD has reaffirmed the position of its member states that the arm's length principle is the fairest and most reliable basis for determining where profits fall to be taxed and that they have rejected the alternatives, global formulary apportionment in particular.

The most significant change is the removal of the distinction between traditional methods and profit-based methods. In principle, all the authorised OECD methods now rank equally (although see below). In consequence, two other major changes are applied: a "most appropriate method" rule; and higher standards of comparability when using profit based methods. In addition, there is now more discussion on the selection of financial ratios or profit level indicators and the standard of comparability to be applied.

The revised Guidelines also stress the fact that these elements are not independent of each other. In applying them the Guidelines now present as an example of "good practice" a process for the analysis process of nine steps (which may need to be iteratively applied at least in part) to describe how these elements can be applied in combination.

Finally, there is considerably more detail on the application of the profit split method and the circumstances in which it is likely to be the most appropriate method.

Most Appropriate Method

The old OECD hierarchy of methods suggested that the CUP method was the most preferred, next came the other "traditional transactional" methods (resale price and cost plus) followed, in "exceptional" cases where the first three methods cannot reliably be applied, by the profit based methods (the transactional net margin method and profit split).

Profit based methods were described as methods of last resort. This distinction is now removed. The basis for removal is the review the OECD member states and other countries with observer status have conducted on the use of these methods in practice over the 15 years since Chapters I-III were first published.

Without a distinct hierarchy, some other basis for determining which method to apply is required. The basis for choosing one method over the others is now expressed as "finding the most appropriate method for a particular case". This comes close to being a "best method" rule except that moderating language is included to make it clear that it is not necessary to examine each method in detail in every case before selecting the one

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believed to be the "most appropriate". Nevertheless, it is clear that some sort of comparison is required and that the basis for that comparison includes the availability and reliability of the comparable data that can be used when applying any particular method.

In addition, a degree of hierarchy is maintained in that the CUP method is to be preferred to the others and traditional methods to profit based methods where they are equally reliable. So, if it is an even choice between the CUP method and TNMM, for example, CUP should still prevail.

Standards of Comparability

The language on comparability has been overhauled both in the introductory sections (to make clearer the central role comparability plays in applying the arm's length principle) and in the detailed Chapter III on comparability analysis in order to raise the otherwise low levels of comparability that the OECD believes are sometimes found when profit based methods have been employed.

The main focus of this work has been on the use of comparables for the TNMM (and, by implication, the cost plus and resale price methods) using publicly available databases. A relatively balanced approach has been taken in that the wording on comparability has been tightened in order to raise standards while more scope is acknowledged for the use of data analysis (e.g., adjustments and the use of statistical methods to draw conclusions from the data that has been found).

For the first time the OECD endorses the use of an interquartile range albeit in terms which do not preclude the use of other statistical approaches that may be appropriate in the circumstances of a case.

The 9 Step Process

In addition to the five comparability factors which have been present in the Guidelines since 1995, a nine step process has been added as an example of how the stipulations and recommendations of the revised Guidelines can be applied in practice. The revised text is explicit that merely following these steps in a formalistic way will not necessarily lead to an arm's length result and, conversely, that following a different process will not preclude an arm's length result. However, what is explicit is that there needs to be a process that is reliable and transparent *i.e.*, one which a tax auditor can examine, follow and test where necessary.

In practice it is likely that the nine step process set out in the Guidelines will become common currency in many countries that follow the OECD approach fairly closely including many that are not member states of the OECD. Taxpayers should expect to be asked what process they followed and for their answer to be compared with the example set out in the Guidelines. They should also be expected to provide documentation demonstrating the conduct of a detailed comparability analysis.

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Profit Level Indicators

Having elevated the standing of the TNMM, the Guidelines now pay close attention to the selection of profit level indicators (PLIs) and detailed guidance is now provided on the most common including return on sales, return on cost and return on capital (or assets) with dedicated paragraphs on the Berry ratio the use of which is now endorsed in certain limited circumstances and discouraged in any others.

Profit Split

The profit split method has also been elevated. Taken together with the tighter approach to comparability which is likely to affect TNMM more than profit split, the result may be increased use of profit split or, at least, more pressure from tax authorities to do so. The revised Guidelines, however, explicitly disavow an intention to encourage broader use of profit split methods either as a primary methodology or as a form of confirming analysis.

The revised Guidelines now contain more detailed analysis of when profit split is likely to be the most appropriate method and, importantly, what its limitations and disadvantages are in practice and how it should be applied. One key element in this analysis is the importance of intangibles and, in the language that finally emerged in the last few months, "valuable, unique intangibles" – intended to distinguish intangibles that may be more routine in nature or which have little value. Where two or more parties have valuable, unique intangibles, the profit split method is said to be likely to be the most appropriate method. The revised Guidelines also explicitly express a preference for objective, rather than subjective, profit split factors

Data & Information

One attraction of the profit split method to tax authorities from the point of view of the OECD member states is that it is two-sided – in other words, it requires detailed information (and hence disclosure of that information) on all the relevant businesses wherever located and a calculation of combined profits. The revised Guidelines address this point explicitly and tacitly approve the preference for two-sided methods. Balance is provided by making it clear that where one-sided methods are the most appropriate, then only limited information related to functions and risks is required from parties other than the one to which that method is applied and that detailed financial information for such parties will not necessarily be required.

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