



EUROPEAN COMMISSION
DIRECTORATE-GENERAL
TAXATION AND CUSTOMS UNION
TAX POLICY
Coordination of Tax Matters

Brussels, 1 March 2004
C1/LDH/

DOC: JTPF/005/2004/EN

EU JOINT TRANSFER PRICING FORUM

Draft Secretariat working document for the EU Joint Transfer Pricing Forum on database searches for comparables

Meeting of Thursday 18 March 2004

**Centre de Conférences Albert Borschette
Rue Froissart 36 - 1040 Brussels**

Contact:

Luc De Hert, Telephone:(32-2) 295.61.20, Luc.De-Hert@cec.eu.int
Wolfgang Büttner , Telephone (32-2) 299.99.38 Wolfgang.Buettner@cec.eu.int

1. BACKGROUND AND OECD CONTEXT

1.1. General

Application of the arm's length principle is generally based on a comparison of the conditions in a controlled transaction with the conditions in transactions between independent enterprises.

Chapter 1, C.i) paragraphs 1.15 to 1.35 of the OECD Guidelines set out the principles and circumstances for a comparability analysis. This analysis should result in a range of prices set for a transaction between independent enterprises reflecting conditions **as similar as possible** to the controlled transaction concerned.

Factors determining comparability are (i) the characteristics of the property or services transferred, (ii) the functions performed taking into account the assets used and risks assumed, (iii) the contractual terms, (iv) the economic circumstances of the parties and (v) the business strategies pursued by the parties.

1.2. Some major areas of difficulties in determining comparable conditions

Economic circumstances:

Besides the product, service or intangible property characteristics, the OECD Guidelines suggest that economic circumstances of relevance to evaluate market comparability could include a large series of factors such as geographic location, size, extent of competition, the availability of substitute goods and services, level of supply and demand, consumer purchasing power, cost of production, transport cost etc.

Functional analysis and contractual terms:

The functions and risks of each entity in a large MNE are not always clearly defined or can change with the business strategies which as such are another volatile comparability factor. The frequency, nature and value of the functions performed, the risk assumed and assets used might be difficult to compare and /or change over time. Linked to this are intra-group contractual terms on credit risk, foreign exchange risk, guarantees etc. which are generally not available in the public domain.

1.3. An illustrative example

A UK company uses services provided by its French parent company. In applying the “arm’s length” principle to determine the compensation for those services for tax purposes, it is necessary to consider what compensation would have been agreed upon by unrelated parties in comparable circumstances for the same or similar services. In doing this, it is necessary to look for comparable transactions between enterprises that are not associated with each other.

From the UK perspective, this involves, amongst other things, looking for comparable services available in the UK market, because there may be significant differences in market conditions between the UK and other countries, such as commercial conditions, interest rates and regulatory framework. It might, therefore, be appropriate to consider enterprises in the UK as being comparable rather than enterprises in other countries.

So one would look, at least in the first instance, for UK enterprises using equivalent services provided by unrelated service providers, whether these service providers were located in the UK, France or in any other country, because an independent enterprise would not accept a price asked for those services if it knew that other potential service providers were willing to ask less under similar conditions. An independent enterprise in, for example, Germany using the services of the French parent company, or equivalent services provided by any other unrelated enterprise, would not necessarily represent an appropriate comparable.

To put the point more generally, when one is looking for comparable enterprises in order to establish the “arm’s length” result of a transaction, one cannot necessarily assume that two enterprises are comparable simply because they are both in the EU. Rather, two enterprises are more likely to be comparable if they are both in the same country.

Even within a single country, it could not necessarily be assumed that two enterprises were comparable simply because they were both in the same country. It would all depend on the particular facts and circumstances.

On the other hand, if the relevant facts and circumstances were the same throughout the EU, it would be possible to use comparables on an EU wide basis.

1.4. The use of database searches for comparables

To support the arm's length nature of intra-group transactions, both the taxpayer and the tax administration have various possibilities for obtaining evidence ranging from the preferred source of information readily available within the company or group to external comparables searches based on databases.

According to the OECD Guidelines, a comparability analysis does not necessarily and in fact not primarily rely on a search for external comparables. Internal comparables, where they exist, should generally be preferred.

Practice shows that, taxpayers and tax authorities often have to rely on external comparables searches, either as a primary (in absence of internal comparables) or as a secondary (test) method of evidence. In those cases, the search for comparable transactions is normally performed on the basis of databases containing financial and economic information of companies.

Where a database is used it is not sufficient to use it alone, but the (often mainly quantitative) data collected from the database should be completed with (qualitative) information obtained from other sources such as industry surveys, market surveys, reports from financial analysts, companies websites, etc . Databases

do not exist in all countries and the access to these databases is in most cases not free of charge. Also, appropriate processing of the information contained in these databases requires often substantive time and resources before an acceptable output is obtained. Certain databases contain only information on companies incorporated in one country, whereas others contain information at a pan-European level.

1.5. Recent developments and OECD context

The OECD does not see the issue of comparability as a formal transfer pricing documentation requirement, but rather as a truly substantive issue that touches the very heart of the arm's length principle.

Comparability is intrinsically an application of Article 9 of the Model Tax Convention which requires a comparison of the conditions made or imposed between associated enterprises with those which would be made between independent enterprises. Understanding what “comparable transactions” and “comparable circumstances” mean is the cornerstone of the arm's length principle – not a mere practical issue.

The OECD launched a public consultation on the global issue of comparability and is developing work that might possibly lead to further developments of their Guidelines. This consultation addresses questions such as the requirement to perform an analysis of transactions vs. an analysis of third party information gathered at company level, the need to rely only on transactions between independent enterprises, the need to obtain third party information relevant to the review of the five comparability factors as stated under section 1.1, the need to ensure objectivity of the list of external comparables, the choice of relevant sources of information, including but not limited to commercial databases and the definition of comparability adjustments where they are appropriate.

In line with the mandate of the JTPF, this paper is limited to the European Community aspects of comparability and only analyses whether there is a strong case to regard the EU market as sufficiently integrated or integrating for tax administrations to accept comparables originating from other Member States, and if so under which conditions. This paper does not assess however under which circumstances the use of database searches for comparables is in accordance with the OECD comparability standard.

The aforementioned database comparable searches are in general of particular relevance when using the transactional net margin method (TNMM) described in Chapter III of the OECD Guidelines. The OECD is currently discussing what the appropriate acceptable comparability standard for TNMM might be.

It should also be noted that transactional profit methods that are based on the profits from particular transactions between associated enterprises, may only be used when traditional transaction methods cannot be reliably applied alone or exceptionally cannot be applied at all. Profit methods should therefore be considered as methods of last resort and their use should be limited to the cases and methods described in the OECD Guidelines.

2. THE AVAILABILITY OF APPROPRIATE DATABASE INFORMATION

2.1. General

Both business and national tax authorities acknowledge that considering the differences in the nature and type of the available information following different domestic disclosure and reporting requirements, it is in some cases difficult to obtain adequate data on third party transactions which fully meet the five comparability factors (see 1.1).

Differences in the detail of the available information and the lack of global accounting standards only aggravate this problem.

Major decisive factor in the reliability and size of the database is of course the source of data input which is not standardized.

Some databases collect their information from publicly available data (e.g. public services or national banks), others collect data from private sector sources (e.g. major credit insurance institutions) or mix several sources.

Country specific databases might contain more detailed data but might also be more limited in the number of companies covered, depending on the information source.

Pan-European databases, which for the reasons explained in the first paragraphs of this section, are not a simple aggregate of country specific databases, might perhaps be less detailed since they need to align the differences in available country specific information to come to one comprehensive system, but relying on different information sources, could cover more companies which increases the possibility to find comparables.

Moreover, the growing level of globalization and economic integration leads to less uncontrolled transactions. Fewer and fewer independent companies facing economic and business conditions and with a functional profile similar to the entity of a MNE trying to comply with the arm's length principle can be found.

Another element to be taken into consideration is that information contained in commercial databases only relates to historical data which sometimes requires adjustments to adapt to the actual situation.

2.2. Characteristics of country specific or regional databases (these databases are established at Member State or regional level and contain data from companies operating in the geographical area covered)

Advantages of this type of database seem to be that they have a higher level of accuracy and precision, might include smaller companies, are in conformity with domestic regulations, and are tailored to the local market and users. *Disadvantages* seem to be, however, that they are sometimes limited in technical performance and that they are not always easy to compare taking into account the above mentioned differences between Member States as regards accounting and reporting requirements.

2.3. Characteristics of pan-European databases (these databases are established at EU-level (or beyond) and contain data from companies operating in the geographical area covered)

Advantages seem to be that they usually have better performances covering all markets and sectors and that they are more reliable as regards financial data. An important *disadvantage* might be that they are possibly less detailed and contain data at a more aggregate level which might conflict with the arm's length transaction based principle.

2.4. Two different issues

The existence of these different types of database initiates two different issues:

(i) the use of country specific comparables originating from pan-European databases in order to reduce subscription costs to a multitude of local databases

(ii) the use of comparables of other Member States originating from pan-European databases

2.5. Possibility to adjust the results of a database search

The result of database comparability searches need to be adjusted to account for material differences of the related transaction and the comparable uncontrolled transaction in function of the different comparability factors.

For the reasons outlined under 2.2 and 2.3, the source of the data itself might already require some adjustments: a country-specific search in a local database might result in a different output than the same country-specific search in a pan-European database. Therefore there might be no reason to give preference to one tool over the other.

The OECD Guidelines in paragraph 1.17 do not give detailed provisions on how adjustments should be valued but they leave flexibility to apply adjustments on a case-by-case basis.

Some of these adjustments such as those for volume effects, margins of distributors or working capital differences can be relatively straightforward considering their more quantitative nature. When it comes to adjustments for qualitative differences such as market conditions or business or product specific factors, a more burdensome and sophisticated approach might be required.

Adjustments therefore need to be considered with much caution, on a case-by-case-basis and in the light of the information available.

It further needs to be reminded that paragraph 1.15 of the OECD Guidelines stipulates that in case it is not possible to make the appropriate adjustments, the comparability standard is not met.

3. STATE OF PLAY IN EU MEMBER STATES

In a large majority of the Member States a local (or other) comparable search is not a statutory requirement. Most of the tax authorities however consider a comparable search as a highly recommended tool.

If applied, preference is given to local searches but in general, regional or pan-European searches are accepted in so far they respect the comparability factors and/or the results do not show any significant differences from the rest of a set of comparables

Although some Member States take the position that the differences between local and regional or pan-European searches are limited, the preference to use the former is being advocated on the basis of regional differences in profit level indicators (PLIs), industry specific differences in PLI or differences in accounting standards.

4. THE BUSINESS POINT OF VIEW ¹²

The business position is clearly that in cases where traditional methods cannot be applied and, therefore, the TNMM method needs to be used, non-domestic comparability searches should be accepted by national tax authorities as documentation to support the arm's length nature of a particular intra-group transaction. This position is mainly based on two fundamental arguments, one examining economic circumstances across the EU as one of the five comparability factors, another one taking into account compliance costs for businesses.

4.1. The existence of a genuine European single market

The most significant legal market impediments among EU Member States have been abolished, and a highly integrated European market is already in place. The economic evidence indicates that European markets are integrating (or have integrated) and that in many ways the levels of price or profit differences among European countries are not meaningfully different from the differences found in other integrated markets, such as Japan or the United States.

The results of a statistical analysis under the TNMM approach, performing (i) detailed comparability tests to develop pan-European and country specific arm's length ranges based on common OECD transfer pricing comparability practice and (ii) tests principally based on industry classification codes, covering 9 industries in 15 EU countries, clearly show that under both types of tests, European arm's length ranges do not statistically differ from country-specific arm's length ranges in almost all cases. Specifically, out of 234 tests conducted testing the statistical equality of upper and lower quartiles of arm's length ranges using 95 percent confidence intervals, 219 tests (approximately 94 percent of the tests) generate results supporting the equality of inter-quartile ranges. In other words, it is highly likely

¹ Contribution by Dr. Heinz-Klaus Kroppen: "Deloitte & Touche White Paper: Is Europe One Market? A Transfer Pricing Economic Analysis of Pan-European Comparables Sets"

² Contribution by Prof. Dirk Van Stappen: "Pan-European versus country-specific searches and Pan-European versus country-specific databases: not a clear-cut issue"

that a country-specific comparability analysis and a pan-European comparability analysis would result in inter-quartile arm's length ranges of results that were not statistically different at a 95 percent level of confidence.

The analysis further gave evidence that when the country-specific arm's length range was statistically different from the pan-European arm's length range, there was no obvious bias or pattern of profit levels to indicate that a particular European country's arm's length range of results is always statistically different from the rest of Europe (differences arose from a particular transactions and not from particular country).

4.2. Keeping the compliance costs at an acceptable level

Notwithstanding that business might understand the reasons why national tax administrations prefer comparable information from their own local databases and markets, the analysis discussed under 4.1 is complemented by the argument that compliance costs for business should be kept at an acceptable level. In cases where pan-European database searches for a multinational enterprise are not accepted, the initial (or additional) search for comparables in several local databases results in any event in additional costs and additional sophistication. The access to databases is not free of charge and companies operating at global level can hardly be expected to pay for access to a multitude of local databases.

Moreover, a more sophisticated and costly search may not be warranted when estimating an arm's length range, i.e. finding an approximation and not an exact number). Indeed in many cases, a local comparables search is not really necessary since the resale price method, cost plus method and TNMM approach yield only approximate results in any event and since, certainly in case of a TNMM approach, there is, as demonstrated under 4.1, consistency of ranges between a country-specific and a European search.

5. POSSIBLE CONCLUSIONS

The basic concern of transfer pricing is to arrive at a range of prices which can be considered as being at arm's length.

To determine the arm's length nature of a particular intra-group transaction and to be in line with the OECD Guidelines, preference should be given to the traditional transaction methods and taxpayers should demonstrate that a reasonable effort has been made to use these methods.

Practical difficulties in applying these methods may require some flexibility leading to the use of transactional profit methods and in particular TNMM without however affecting the aforementioned order of methodology advocated by the OECD.

In using the TNMM methodology, database searches for comparables play an important role to approximate arm's length conditions.

Although such searches do have some weaknesses, as discussed above, when handled with the necessary precautions, they seem both for taxpayers and tax authorities the most effective mechanism to produce benchmarking data.

As a consequence of the further globalisation and integration of the economy and the deepening of the internal market, it should also be considered that a country-specific search for comparables does not always generate an output that complies with the comparability factors discussed before.

Statistical analysis shows that for the use of the TNMM pan-European or non-domestic comparability analyses may produce reliable arm's length ranges of results similar to country specific arm's length ranges, although they may not be appropriate in all cases.

Question 1: Under which circumstances could national tax administrations agree to accept country specific comparables originating from pan-European database searches ?

Question 2: Under which circumstances could national tax administrations agree to accept comparables from other EU Member States originating from pan-European database searches?

Question 3: Do Members agree with following draft conclusions:

Recognising that the use of the TNMM remains a method of last resort, and considering that database comparability searches are, when using this method, an important tool to assess the arm's length nature of intra-group transactions, tax administrations are recommended to accept domestic or non-domestic comparables found in pan-European databases and to evaluate them with respect to the specific facts and circumstances of the case.

Not impeding the right of a tax administration to make an adjustment if it judges that the arm's length principle has not been met , national tax authorities should accept that, where a taxpayer has demonstrated that he has made reasonable efforts to first use the traditional transaction methods recommended by OECD and has soundly documented his database comparability searches, the use of non-domestic comparables should not subject the taxpayer to penalties for non-compliance.