



EUROPEAN COMMISSION

DIRECTORATE-GENERAL

TAXATION AND CUSTOMS UNION

Direct taxation, Tax Coordination, Economic Analysis and Evaluation

Direct Tax Policy and Cooperation

Brussels, June 2016

Taxud/D2

DOC: JTPF/007/2016/EN

EU JOINT TRANSFER PRICING FORUM

DRAFT REPORT ON THE USE OF COMPARABLES IN THE EU

Meeting of 23 June 2016

DISCLAIMER:

This is a DG TAXUD working paper prepared for discussion purposes. It does not represent a formal Commission or Commission services position or policy.

Contact:

Hartmut Förster, Telephone (32-2) 29.55.511

Morgan Guillou, Telephone (32-2) 29.54.146

E-mail: taxud-joint-transfer-pricing-forum@ec.europa.eu

Contents

- 1. Background 4
- 2. Introduction: context and scope 4
- 3. Comparable search 5
 - 3.1 General Aspects..... 5
 - 3.2 Search strategy proposal..... 6
- 4. Specific aspects dealing with internal comparables 7
 - 4.1 Selecting internal comparables..... 7
 - 4.2 Using internal comparables 8
- 5. Specific aspects dealing with external comparables 10
 - 5.1 Sources of information in the EU..... 10
 - 5.2 Selecting external comparables 11
 - 5.3 Processing and interpreting external comparables 13
- 6. Specific aspects of comparability adjustments..... 15
 - 6.1 Observation in practice: 15
 - 6.2 General aspects to be considered for comparability adjustments 15
 - 6.3 Specific comparability adjustments: 16
- 7. Update and way forward for pan-European comparables 17
- 8. Assessing the reliability of the comparability analysis 19

Secretariat's Note:

This draft report is based on contributions from Non-Governmental Members and Member States further to the two JTPF meetings of respectively 22 October 2015 and 18 February 2016 and the conclusions reached on the Discussion Paper on Comparables in the EU (JTPF/001/2016/EN) at the JTPF meeting in February 2016.

It also takes into account the preliminary¹ findings of the study launched by the Commission on the use of Comparables within the EU, commissioned with Deloitte Belgium. A draft executive summary of the study (JTPF/008/2016/EN) has been sent to JTPF members together with this draft report.

The draft report contains 10 recommendations in boxes at the end of each section. Three discussion points are also inserted in section 2 (Introduction), section 6 (par. 6.3) and section 8 respectively.

This document will be discussed at the JTPF meeting on 23 June 2016.

¹ At the time of the preparation of this report the study was not formally approved by the Commission.

1. Background

1. The EU Joint Transfer Pricing Forum (JTPF), as part of its work programme for 2015-2019 ("Tools for the rules"), addresses the use of comparables in the EU (section 2.2 doc. JTPF/005/2015). Non-Governmental Members and Member States were asked to provide contributions as part of the preparation of the two meetings of 18 February 2016 and 23 June 2016. Those were considered in the preparation of an overview on the current state of play, issues and possible solutions.

The Commission commissioned a study to Deloitte Belgium (the "Deloitte study"²) to assess the access to and the quality of comparable data, as well as the impact on the comparability analysis in the 28 Member States of the European Union. The highlights and key findings of this study are presented in document JTPF/006/2016/EN for discussion purposes.

A draft discussion paper on "Comparables in the EU" was prepared and discussed at the JTPF meeting in February 2016 (doc. JTPF/001/2016/EN).

2. Introduction: context and scope

2. The 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 parties ('comparability analysis'). In the revised Chapter I of the OECD Transfer Pricing Guidelines ('TPG'), the comparability analysis as a whole is described as including two components, (i) the **delineation of the actual transaction** as part of the risk and functional analysis and (ii) the **comparable search**, described as "*compar(ing) the conditions and the economically relevant circumstances of the controlled transaction as accurately delineated with the conditions and the economically relevant circumstances of comparable transactions between independent enterprises*"³ These two components are part of the typical process of a comparability analysis⁴, whereas the delineation is part of step 3 and the comparable search is addressed in steps 4 to 9.
3. Delineating the transaction (see component (i) above) and drawing conclusions from the risk analytical framework⁵ is the first step and separate from the search for comparables. The delineation has some significant consequences on the result of the comparability analysis. The search for comparables therefore needs to be systematically positioned *vis-à-vis* the delineation of the transaction. It is the delineated transaction, which governs the comparables search and not *vice versa*.
4. This report contains various recommendations for increasing in practice objectivity and transparency in the context of a comparable search in the EU. The purpose here is to make progress towards best practices used and to find pragmatic solutions for companies doing

² Reference to the "Deloitte study" hereafter should be construed with reference to the Executive summary (JTPF/006/2016/EN)

³ See paragraph. 1.33 & seq. TPG

⁴ See paragraph 3.4 TPG

⁵ See paragraph 1.60 TPG

business in the EU. The main focus is put on the second aspect, *i.e.* the comparable searches and how to improve them in the EU.

For Discussion:

Do you agree with the sections above?

3. Comparable search

5. Finding acceptable comparable data is regarded as a challenge in the practical application of transfer pricing. It is recognised that complete elimination of judgments from the selection of comparable data would not be feasible, but also that much can be done to increase objectivity and ensure transparency in the application of subjective judgements⁶.
6. A balance has to be found between (i) care, thought, analysis and judgment, on the one hand, and, (ii) ensuring consistency and maximizing objectivity, on the other hand. The first (i) attributes need to be exercised when searching for comparables but the second term (ii) is crucial in the context of the EU to ensure a proper implementation of the TPG and best practice and therefore to prevent tax disputes.

3.1 General Aspects

7. At the outset, some general objectives should govern a comparable search.

Draft Recommendation 1: A common approach for a Comparable search in the EU relies on the following general objectives:

- a) The emphasis should be put on the quality of the analysis rather than its quantity.⁷
- b) The comparable search should be in line with the principle of consistency.⁸
- c) The burden on both taxpayers and administrations as regards comparable searches execution and review should be proportionate in relation to the objective of increasing legal certainty and transparency (*i.e.* focusing on key aspects to be documented in the search).
- d) Taxpayers should also consider the impact of respectively (i) the delineation of the transaction and (ii) the risk analytical framework on different steps of the comparable searches during the following steps: the definition of the search terms and scope, the screening and rejection steps and the possible adjustments to be combined.

Question to Delegates:

Do you agree with these general objectives?

Are there any other general objectives that should be included?

⁶ See paragraph. 3.46 TPG

⁷ See Par. 3.33 TPG

⁸ Consistency refers here to the application of a coherent end-to-end approach in this step-based comparable search, the said search also being congruent from one year to the other, with justifications being provided on variations or changes in the approach, if any.

3.2 Search strategy proposal

8. Setting a transfer pricing policy in line with the arm's length principle by adopting a transparent approach verifiable by a reviewer requires the exact identification of all the steps needed in order to be able to identify the most reliable comparable information available on the market.
9. As mentioned in Para. 3 the delineation of the transaction should have been conducted prior to the search process: the better the transaction is defined, the more accurate the search will be. Additionally, the risk analysis shall be integrated in the comparability search (following an "end-to-end approach").

Example:

The tested party is characterised as a distributor but it is then established under the Chapter I-D analysis of the TPG that it does not assume the inventory risk. As regards the comparable search, the question to be addressed in particular is whether a distributor should be searched and then working capital adjustments be done, or, if it would be more appropriate to search comparable data carrying out marketing operations rather than distribution.

10. Both NGMs and Member States agreed on the necessity of precisely identifying chronological steps and common milestones, as part of the comparable search. Moreover, the following general recommendations, reflecting good practice in the EU, should be made in order to facilitate the transparent step-based analysis just described.

Draft Recommendation 2:

- a) The chronological steps taken in a comparable search, as well as the result of these respective steps and any related judgement, should be made transparent to any reviewer.
- b) Overall, comparable searches should not aim to capture only "best" comparables but rather a statistically significant sample of reasonable comparables. Comparable Searches are about sampling, not about comprehensive surveying.
- c) The search should start with a broad review of the available sources of information. The availability of data and its impact on the acceptability and reliability of the comparable search shall be considered at this stage. Moreover, all sources, including external data bases, companies' internal management and information systems, documentation used internally by marketing, purchasing and pricing departments (to set or negotiate prices) and any other relevant information⁹, shall be exploited to substantiate and support the search for comparables.

⁹ Some Business Members indicated that other information than external data base can be of particular interest, particularly for SMEs or tested parties evolving in a specific sector or industry with a limited market and few competitors. Data bases searches would need to be comprehensively analysed in light of such complementary

- d) Judgment should be used, for instance to assess the above-mentioned information source and possibly complement it at the various steps of the process.
- e) A deductive approach should be followed, noting that the additive approach can serve as an important source of information for further refining the parameters of the deductive analysis and the initial sample.
- f) The comparable search should be appropriately documented and supported, particularly by mentioning the financial data on the comparables used and the respective sources (database references). This should include sufficiently detailed search and rejection matrices and should consider all information relevant to be provided in cases where tax authorities may not be able to verify the authenticity of the information and/or have access to the data.
- g) Evidence gathering should be archived and electronic files of the document that support the comparables search should be maintained.

For discussion:

Do you agree with the recommendations above?

Are there any other recommendations that should be included?

4. Specific aspects dealing with internal comparables

4.1 Selecting internal comparables

11. Internal comparables are defined as transactions between one party to the controlled transaction and an independent party. The advantages of the use of internal comparables are the easier access and the availability of more detailed information as highlighted in the TPG.¹⁰ However, it has been observed in practice, that comparable searches were quite often short cutted or insufficiently documented by the taxpayer. Furthermore, there may be an asymmetry of information between the taxpayer and the tax administration as regards the availability of potential internal comparable as the taxpayer – naturally – has a more complete overview of the business transaction within the MNE group/the respective MNE Group Member.

Draft Recommendation 3:

- a) Potential internal comparables should be examined prior to external comparables, even if they are rejected in the end.
- b) Taxpayers having third party transactions with relevance for the comparability analysis of the transaction under review should provide an overview of these third party transactions in their documentation.

information (including in particular import & export data, external lists of prices purchased, market development, raw industry prices, etc.)

¹⁰ See Par. 3.27 TPG

- c) In this respect, transactions at the broader level of the group (i.e. not only at the level of the single entity involved in the tested transaction) should qualify as "internal comparables".¹¹
- d) Specific situations should be admitted recognising internal comparables as part of restructuring operations or acquisitions, subject to adjustments¹² and prior check of "things and circumstances standing thus" test. This could cover (i) situations where an acquired entity had entered into uncontrolled transactions when it was external to the group (these transactions becoming then fully "tested" transactions after the acquisition or restructuring) (ii) internal comparables of the acquired entity. The observations (i) and (ii) may appear to be particularly useful in complex transactions or transactions dealing with intangibles where comparables can be difficult to find.¹³
- e) Current practices of using Internal Comparables (particularly for ICUPs) in combination with or to support other methods could be extended.

For discussion:

Do you agree with the recommendations above?

Are there any other recommendations that should be included?

4.2 Using internal comparables

12. Generally speaking, internal comparables may be used when applying the Internal Comparable Uncontrolled Price (ICUP) or for other methods, when determining a margin¹⁴. The Deloitte study states that using internal comparables is a preferred option in all EU Member States¹⁵. By contrast, the ICUP tends to be widely dismissed by tax administrations, due to lack of data or material differences in the comparability factors. Tax administrations might show a demand of comparability, which is *de facto* higher than for external searches due to the intrinsic nature of such comparables, which allow having access to more information (and therefore more reasons to reject them).
13. As regards the use of internal comparables for other methods than the ICUP method, (especially the transactional net margin method (ITNMM)) the study concludes that the use of internal comparables is not rejected in national law and administrative guidance but rarely observed in practice. There seems not to be any case law or guidance available at

¹¹ And complying with par. 3.24 TPG

¹² The same types of adjustments as the ones mentioned above should apply.

¹³ see section 4.1 of the Deloitte study

¹⁴ Paragraphs 2,22, 2,40, and 2.58 TPG

¹⁵ See also Commission Staff Working Document, "Report on the Activities of the EU Joint Transfer Pricing Forum in the Field of Documentation Requirements", SEC (2005)543 final, Sec. 2.3.1 (Para. 38) : « Internal comparables where they exist should be preferred to external comparables when applying traditional methods and the TNMM (see paragraphs 2.15, 2.33 and 3.26 of the OECD Guidelines). However, it is not always the case that the taxpayer has internal comparables and because of the difficulties in locating adequate external uncontrolled transactions for which the comparability analysis can be satisfied, in practice taxpayers as well as some tax administrations frequently rely on publicly available data, e.g. net profit data from commercial databases (although the use of such commercial database is neither prescribed by the OECD Guidelines nor by EU countries' domestic legislations). »

national level. The Deloitte study, however, suggests that the ITNMM could prove useful to support another method¹⁶.

Draft Recommendation 4:

- a) When used for small transactions and SMEs the costs for the taxpayer should be considered as internal comparables are directly available to the taxpayer. By contrast, a search for external comparables, especially when obtained through the use of commercial databases, may cause significant costs.
- b) It should be envisaged to collect and build upon the few existing and recognized cases of ICUPs¹⁷ within the EU.
- c) Sufficient details shall be provided on the evaluation of internal comparables, *i.e.* documenting what the approach taken is, the result obtained and the reasons for accepting/disregarding these potential internal comparables.
- d) The possible use of Internal comparables with considering correlated appropriate adjustments should not routinely be precluded¹⁸.
- e) Practical considerations should allow more flexibility in the comparability test in certain circumstances and in cases where less satisfactory external comparables are available, even for applying the TNMM method¹⁹.
- f) Experience and case law from third countries reflect admitting the use of Internal comparables should be collected: they show that transactions of sensitive importance for Transfer Pricing practitioners are possibly involved (e.g. financial services such as broking, IT development services, transfers and buy-in of intangibles, other services), even for applying the TNMM method (so-termed "ITNMM" with a segmental approach.²⁰

¹⁶ See Deloitte Study section 4.1 and section 8-§26 hereafter regarding use of more than one method

¹⁷ A few cases of ICUPs have been identified as regards case law decisions in EU28, dealing with interest, goods, commissions and services such as retailing/warehousing, whereas the sectors using more ICUPs tend to be more focused on generic commodities like products or services such as banking, agro food, chemicals, pharma, ICT, automotive –*e.g.* parts, engineering- (source: Deloitte study).

¹⁸ The Deloitte study notes that ICUPs are mostly used for goods transactions and loans, rarely used for Intangible transactions and in-existent for the rest. Practices in non EU countries show a wider use of ICUPs and even CUP/TNMMs. The Deloitte study refers to some adjustments practiced in the EU addressing differences such as product quality, transaction volume, contractual terms, geographic market, embedded intangibles, foreign currency risks.

¹⁹ The Deloitte study establishes that " use of internal comparables under TNMM ('ITNMM') or other profit based methods happens seldom due to difficulty to assess 'net margin' at transaction level, subjectivity in segmenting accounts or differences in fact patterns between intragroup and third party functions and risks allocation. However, the ITNMM appears to be helpful, in certain circumstances, to support another method." Cases relate in particular to production entities selling to dependent and independent entities, selling entities buying from dependent and independent entities, joint venture cases (either manufacturer or distributor) (section 2.3.1.2 of the Deloitte study).

²⁰ See Genisys Integrating System 2013; Interra Information Technologies India (P) Ltd. Vs. DCIT (ITA No. 5568&5680/Del/2011); Destination of the World (Subcontinent) Pvt. Ltf 2014 & 2011; J.P. Morgan P.V. Ltd 2006, -- Use of ITNMM appears to be admitted in the Indian case law when the turnover realised as part of the internal comparable transaction(s) considered amount at least to 15% of the total tested entity's turnover.

For discussion:
Do you agree with the recommendations above?
Are there any other recommendations that should be included?

5. Specific aspects dealing with external comparables

5.1 Sources of information in the EU

13. The work conducted at the level of the EU JTPF (see introduction), as well as the Deloitte Study give a comprehensive overview of the state of the art regarding the potential sources for external comparables and the various stages of an external comparable search (*i.e.* selection and screening of the comparable data, use of multiple year data, treatment of the interquartile range and adjustments).
14. A comparable search of external potential comparable data can be performed reliably only when sufficient information is available on comparable companies. The Deloitte study shows overall the current level of availability and accessibility as well as the reliability of data, which may be used for applying traditional transaction methods (especially the CUP²¹) and transactional profit methods (especially the TNMM). Overall a substantive amount of data is encountered for the EU Member States which is expected to be in most cases sufficient and satisfactory in order to conduct comparable studies under the profit-based method (TNMM). The feasibility of the selection (incl. tests such as independence test, rejection of potential comparable data being in a loss position or start-up companies, choice and application of different PLIs), is most likely in this context and adjustments can be done. Business and Academia members of the JTPF have underlined that the situation has improved over the last two decades and the availability and quality of data is comparable to what is experienced in some non-EU countries, in particular major key trade partners.
15. As regards the availability of quantitative and qualitative data, the study highlights some differences between countries and sectors which can be explained in particular by local statutory reporting requirements. The accessibility and availability of data vary substantially across Member States without being an obstacle to conduct comparable searches in these Member States.

²¹ "Comparable Uncontrolled Method" - see Milestones 5 – 7 of the Deloitte study – Section 3.

Draft Recommendation 5:

- a) Inconsistencies in the industry classifications between countries require the application of judgment. It is recommended to concentrating more on a comprehensive selection and combination of precise keywords rather than a narrow selection of industry codes when defining search strategies. It is also recommended to use internal sources of the taxpayer (industry codes of the taxpayer and of the competitors, additional information²²).
- b) To capture all potential comparable companies in the course of a pan European search, with the intention of also producing local sets, the search strategy would need to be adjusted and be very broad in certain countries while narrow in others. Such approach would lead to that the number of companies to (manually) review will be too many. Consistency should prevail.
- c) There is no reporting requirements in some Member States on 'cost of goods sold', R&D expenses, *etc.*, which makes it difficult to use methods based on gross profit and to assess functional intensity – Some Member States are currently working on collecting additional information about unrelated enterprises and transactions in their region (*e.g.* Baltics). The outcome and impact should be assessed once available.
- d) For royalty and license searches (CUP), Member States are currently very dependent on databases that primarily contain US agreements. A similar database for European agreements should be developed as such searches appear to be crucial for transactions involving intangibles.²³

For discussion:

Do you agree with the recommendations above?

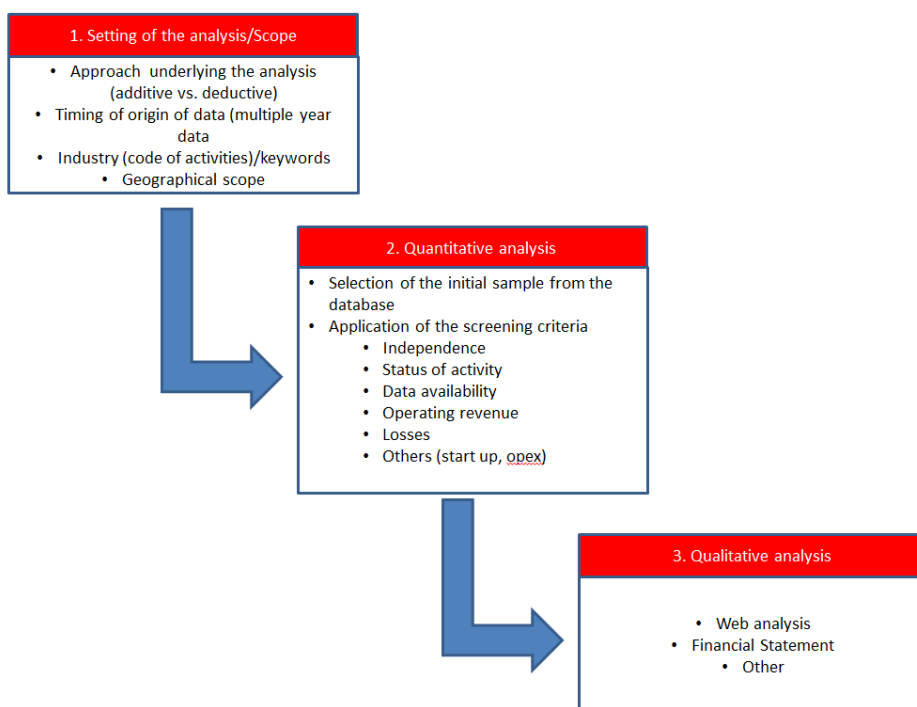
Are there any other recommendations that should be included?

5.2 Selecting external comparables

16. The following diagram provides an overview of current practices applied by both taxpayers and tax administrations and relies on information collected as part of the Deloitte study and contributions from the Business and Academia Members and Member States:

²² In some cases (*e.g.* eye glasses wholesalers) specific industry codes do not exist whereas in some other cases there are more than one potential industry code (*e.g.* manufacturers of foods).

²³ For a similar recommendation, see Final Report from the Expert Group on Intellectual Property Valuation, Directorate General for Research and Innovation, 2014, page 54: "*creating a database of license agreements in which the confidential information is not disclosed but which provides information on royalties paid in different technological fields, or for different kinds of trademarks, etc*" – A broader notion could be alternatively used based on third countries' practice (*e.g.* notion of "material agreement" see Item 601 of Regulation S-K (USA)).



Following the above depicted approach, starting from an appropriate analysis of the controlled transaction, is expected to provide a good basis to reach an outcome aligned with the substance.

In detail, the following recommendations should be followed when performing such a search:

Draft Recommendation 6: Step 1- Setting of the analysis/Scope

- a) Taxpayers should use and document a Boolean query search based on industry codes, inclusion keywords etc. ensures objectivity in the process.
- b) Quantitative measures should be applied in the search process of external databases (automatic search).
- c) A manual and qualitative review should be made to exclude some comparables after the quantitative review. It involves subjective judgment and needs to be properly documented.

For discussion:

Do you agree with the recommendations above?

Are there any other recommendations that should be included?

Draft Recommendation 7: Step 2- Quantitative analysis

- a) A reasonable independence test should be applied. The following threshold should be considered: it could be referred to a company with a known recorded shareholder, none of which with an ownership percentage (direct, total or calculated total) over 50 %, but having one or more shareholders with an ownership percentage above 25 %²⁴.
- b) Turnover thresholds should be applied based on facts and circumstances of the tested party (and should be justified accordingly). Applying fixed turnover threshold should not be considered as a good practice.
- c) Potential comparables with a low risk profile being in a recurring loss position should be excluded. On the other hand loss-making companies should overall not be rejected from the sample, based on this sole ground.²⁵
- d) Available accounts from listed companies (*i.e.* publicly traded comparables) should not be excluded as a source for comparable information for this sole ground.
- e) Diagnosis ratios should be acceptable and should be practiced, if they have the effect of improving the reliability of the benchmarked sample, for instance to test transactions involving services providers²⁶, contract manufacturers²⁷ and R&D contract²⁸: the terms and conditions under which they are applied should be justified.

For discussion:

Do you agree with the recommendations above?

Are there any other recommendations that should be included?

5.3 Processing and interpreting external comparables

17. Beside issues dealing with comparability adjustments (see section 6), contributions from the JTPF Member States and from Business and Academia Members, as well as the Deloitte study, laid the emphasis on (*i*) use and interpretation of the range through statistical methods and (*ii*) treatment of multiple year data, as areas for which converging guidance would be useful.

²⁴ Most Member States confirmed that a %-based indicator reflecting a maximum share of interest owned in subsidiaries is practiced, the actual ratio considered in EU28 ranging between 25% and 50%. Applying a common approach in this respect would be particularly useful in case of joint-audits and dispute resolution. See also the Deloitte study's conclusions (MS21),

²⁵ This is a common practice in the MS according to the contributions received.

²⁶ Based on indicator such as the Level of inventory, the level of property, plant, equipment (PPE)

²⁷ Excluding companies with ratios such as R&D/ Sales or Intangible/Balance sheet exceeding a certain percentage.

²⁸ Excluding companies with a ratio PPE & Equipment/Sales or total Balance sheet or whose ratio Inventory/sales exceed a certain percentage.

Draft Recommendation 8:

As regards practice related to the **use of an interquartile range:**

- a) Based on converging practices, defining a minimum or maximum number of comparables to be included in a range should not be required. The possibility to accept one or two comparables only should generally not be excluded (*e.g.* when applying the CUP method or if the comparability factors are fully met). On the other hand, there is a general acceptance according to which, if a narrowed search on comparables is performed, the ranges should not be extremely wide, based on the simple fact that liquid and well-functioning markets should not lead to extremely diversified results.
- b) The full range should not be excluded when there is a high degree of comparability and reliability. On the other hand, using statistical method to ensure the reliability of the selected benchmark is a common practice: few Member States require a sufficient number of potential comparables to use such statistical methods. Most Member States refer to the interquartile range. Using other tools (*e.g.* the 10th percentile range) should be acceptable, if presented by the taxpayer, properly justified and used consistently.
- c) The big majority of Member States accept positioning the Arm's Length principle within the interquartile range with no further adjustments to the median, with some exceptions: in case of joint audits or dispute resolution cases, such an approach should prevail.

As regards practice related to the **use of multiple year data:**

- d) The use of multiple year data in a comparability analysis is not a systematic requirement^{29 30} but can add value to the analysis. Multiple year data may be used to better understand the controlled transaction³¹ and provide useful information on the comparables. In this respect the effect of business and product/intangible life cycles or anomalies³² in third party information would need to be considered to determine the applicable period or even warrant consideration of a multiple year data.
- e) The use of averages may also improve the reliability of a range³³.
- f) As regards the data considered in a multiple year analysis, comparables should not be excluded for the simple reason that they report losses in a limited number of years covered by the analysis.
- g) The time period covered by a multiple year analysis will finally depend on the facts and circumstances of the case but should cover at a minimum 3 years. An aspect to be considered when setting the price at the time of the transaction³⁴ is the delay of availability of information on third party transactions.³⁵
- h) Multiple year data ordinarily should not be considered for purposes of applying CUP.

²⁹ See Par. 3.75 & seq. TPG.

³⁰ Following the Questionnaire to MS it seems that no MS systematically requires the used of multiple ear data.

³¹ See Par. 3.76 TPG.

³² complete and accurate data shall be available for the whole period.

³³ See Par. 3.79 TPG.

³⁴ Taxpayer should endeavour to determine transfer prices for tax purposes in accordance with the arm's length principle, based upon information reasonably available at the time of the transaction, paragraph 27 Chapter V TPG.

³⁵ See e.g section 2.4.5.2 of the study.

For discussion:

Do you agree with the recommendations above?

Are there any other recommendations that should be included?

6. Specific aspects of comparability adjustments

6.1 Observation in practice:

18. The study concludes that working capital adjustments (related to account payables, account receivables and inventories in particular) remain a common practice as well as certain accounting adjustments which tend, however, to be more limited, certainly due to converging accounting standards within the EU. Most of the accounting adjustments deal with foreign exchange difference. No relevant experience was found on applying location saving adjustments, suggesting their general scarcity. As regards risk related adjustments, particularly linked to the risks considered in the revised OECD TPG there is currently no noticeable practice within the EU.

6.2 General aspects to be considered for comparability adjustments

19. Following the TPG³⁶, comparability adjustments should be considered if (and only if) they are expected to increase the reliability of the result. Whether comparability adjustments should be performed (and if so what adjustments should be performed) is a matter of judgment that should be evaluated in light of costs and compliance burden. A further aspect to consider is the quality of data subject to the adjustment. While a high degree of detailed information can be expected for the controlled transaction, the information on uncontrolled transaction, especially on external comparables may be limited and consequently limiting the possibility for accurate adjustments.

Draft Recommendation 9:

Adjusting potential comparables should be considered only at the last stage of the overall analysis, although being consistent with the former steps - end-to-end approach) and should meet the following criteria:

- a) Should not be applied to unsuitable comparables, *i.e.* the comparable data obtained should be the result of a proper selection, screening and filtering of potential comparables.

³⁶ Chapter III section A.6 TPG.

- b) Should be kept as simple as possible and applied only if comparability is improved (*i.e.* meeting the materially-affecting-difference test^{37 38})
- c) More guidance should be developed on the above mentioned materially-affecting-difference test.³⁹
- d) Should be applied only at the level of the benchmarked sample and not the tested party. A limited number of corrections should be applied, also to avoid in practice correcting twice the same issue through different adjustments or accounting twice a difference, *i.e.* when setting the screening criteria and when considering the adjustments.
- e) Should be reasonably accurate⁴⁰ and fit with the overall approach, as initially set up with reference to the properly delineated transaction and the risk analytical framework ("end-to-end approach").

For discussion:

Do you agree with the recommendations above?

Are there any other recommendations that should be included?

6.3 Specific comparability adjustments:

20. According to the results of the Deloitte study and based on the contributions from Business and Academia and Member States Members, comparability adjustments remain limited in type and numbers within the EU:

- a) Working capital adjustments (related to account payables, account receivables and inventories in particular) are the most often applied adjustment. The Annex to Chapter III⁴¹ contains an example of such a working capital adjustment.
- b) Accounting adjustments tend to be more limited, certainly due to converging accounting standards within the EU. Most of the accounting adjustments deal with foreign exchange difference adjustments.
- c) Market adjustments related to volume of sales, terms and conditions of sales and payments, credit terms are common practices within the EU.
- d) Several types of adjustments are rarely developed and could be further explored, *e.g.* Balance sheet adjustments and asset intensity adjustments.
- d) Risk related adjustments, particularly linked to the how the potential comparables include the same level of risks and management of risks⁴², are currently envisaged but not reflected in

³⁷ See par. 1.40 TPG.

³⁸ Non EU countries, *e.g.* the USA provide for more details about it in their guidelines see US Treasury Transfer Pricing Regulations §1.482-1(d).2 "Standard of comparability".

³⁹ No Member State has declared having administrative guidelines with respect to the above-mentioned "materially-affecting-difference test"³⁹: assessing such a material difference is in practice approached on a case-by-case basis using judgement and referring to general principles of prudence and proportionality. During evaluation procedure taxpayers are asked to explain how they established which conditions have a definite and reasonably ascertainable effect on the price (profit), how they affect the price and how the uncontrolled comparable(s) was(were) subsequently adjusted. In case some conditions are not evaluated as being material, the taxpayers shall substantiate how they came to such conclusions as well

⁴⁰ For illustration, in the framework of applying the CUP method see par. 2.15 and 2.16 TPG

⁴¹ TPG

any noticeable practice within the EU. There is a common interest in further developing such adjustments.

For discussion:

Given the variety of possible adjustments, their high reliance on the facts and circumstances of the case and their rather limited relevance in practice, *i.e.* in light of actual differences encountered and the information expected to be available,

- for which adjustments do you think practical guidance examples should/can be provided comparable to the Annex to Chapter III of the TPG in light of the information expected to be available in the EU?

If you have examples available, please submit them to the Secretariat

7. State of play and way forward on pan-European comparables

21. Following the TPG the use of non-domestic data may be appropriate in the case of a MNE performing similar transactions in several countries where the economic circumstances in these countries are in effect reasonably homogenous⁴³. Beyond this case the determination of whether non-domestic comparables are reliable has to be made on a case-by-case basis and by reference to the extent to which they satisfy the five comparability factors⁴⁴. Consequently, the use of non-domestic comparables will depend on (i) the extent to which the comparability factor matters (taking into account the transfer pricing method used) and (ii) whether the search is based on a market which can be considered being reasonably homogenous.

22. The EU Code of Conduct on Transfer Pricing Documentation (“EU Transfer Pricing Documentation” (EU TPD)) adopted by the European Council on 27 June 2006⁴⁵ provides for the following guidance regarding comparable searches using pan-European databases :

⁴² See par. 1.73 TPG, regarding risks such as strategic risks or marketplace risks, infrastructure or operational risks, financial risks, transactional risks, hazard risks.

⁴³ See Par. 1.112 and 1.113 TPG

⁴⁴ See Par. 3.35 TPG

⁴⁵ IP 06/850

Member States should evaluate domestic or non-domestic comparables with respect to the specific facts and circumstances of the case. For example, comparables found in pan-European databases should not be rejected automatically. The use of non-domestic comparables by itself should not subject the taxpayer to penalties for non-compliance.

23. These provisions rely on two EU JTPF surveys of 2004 addressing this subject in specific context of the EU Single Market. The survey “*Is Europe One Market?*” was performed to examine the appropriateness of using pan-European databases rather than local databases. Overall, the survey concluded that the EU is one single market for TNMM transfer pricing purposes, and that an arm’s length range of results based on a pan-European set of comparable companies provides a reliable measure for an arm’s length result. The survey “*Pan-European versus country-specific searches and pan-European versus country-specific databases: not a clear-cut issue*”⁴⁶ showed that almost none of the EU Member States required a local comparables search.
24. The Deloitte study has updated these two surveys. The main conclusions are confirmed and supported covering all EU Member States and a broader scope in terms of sectors and functions performed. The current state of play is such that pan- European comparables searches, derived from pan- European databases, are generally acceptable to European tax authorities. The above-mentioned provisions of the EU TPD shall remain unchanged based on the update of the two-above mentioned surveys. Additional guidance can be envisaged in view of improving consistency as well as cooperation between Member States and dispute prevention.

Draft Recommendation 10:

- a) Applying pan-European comparable searches can benefit both taxpayers and tax authorities in terms of reducing compliance costs, as well as increasing transparency, consistency and quality through an homogeneous documentation within the EU⁴⁷. It may reduce some areas of disputes and is required in case of request of bilateral or multilateral APAs or as part of joint tax audits.
- b) The EU market offers certain opportunities in situations characterising a lack of comparables: it is admitted by a majority of Member States to conduct search on similar functions and assets if no comparable can be identified when screening on product comparability⁴⁸. In addition, it could be envisaged to extend the comparable search to other products, for which the markets present similarities in terms of market structure and/or level of competition. This test of "similar market structure/level of competition" is commonly applied in the competition law area. Even if the notion of relevant market

⁴⁶ DOC: JTPF/006/BACK/2004/EN

⁴⁷ The conclusion in terms of benefits is here similar to what can be concluded from applying a common EU TPD approach in all EU 28 MSs.

⁴⁸ Nota: in the survey conducted by the JTPF a certain number of MSs have mentioned that they consider a research based on function rather than products as acceptable in the absence of acceptable comparables.

is implemented differently in competition law area from what would prevail in transfer pricing, this due to different objectives and circumstances in which such notion has to be tested, some elements of the competition law practice could be beneficial in transfer pricing, when comparables cannot be found or need to be strengthened. As an example, this could result in considering benchmarking the distributors of industrial goods rather than distributors of cars simply at EU28 level, or distributors of spare parts together with distributors of cars, distributors of laptops/printers and other hardware.

- c) In practice, conducting such a pan-EU comparable search in accordance with the OECD TPG requires to refer to the relevant geographic market⁴⁹, which generally includes the territory in which the MNE operate as long as it is homogeneous. Conversely, given the characteristics of the EU market and considering MNEs' business models, limiting a search to domestic data can lead to inappropriate conclusions
- d) Based on the survey "*Europe One Market*" as updated, it can be concluded on the overall homogeneity of the EU market. The characteristics of the EU market are such that one can expect that the effect of location savings which have not been passed on to customers or suppliers are reflected in the comparables drawn from a reasonably homogenous territory. The additional investigations made in the Deloitte study concludes that there is access to sufficient comparable data in the countries having lower cost on labour, capital etc. so that the effect of location savings to be reflected in the comparables drawn from these territory, and no adjustments should be necessary.⁵⁰
- e) Taxpayer should document the reasons underlying the choice of the region on which his comparable search is based including the extent to which he considers that the economic circumstances matter for the comparable search.
- f) The updated conclusions on the above-mentioned 2004 studies also confirm that Member State and taxpayers shall defend a similar pan-European approach when defending comparable searches in files involving third countries.

For discussion:

Do you agree with the recommendations above?

Are there any other recommendations that should be included?

8. Assessing the reliability of the comparability analysis

25. The review on the use of comparables in the EU showed a broad variety of potential sources for obtaining information on comparable transactions the EU a in with a high level of detailed information. However, whether the use of comparables in the EU will finally result in a reliable result for a case under review will depend on the facts and circumstances of the case, *i.e.* whether the information available is actually sufficient for

⁴⁹See TPG Par. 1.112 and 1.113

⁵⁰ Several MSs have taken this position in the survey conducted by the EU JTPF secretariat.

pricing the transaction (s) under review and finally the way the information is used. The analysis further confirmed that a comparability analysis requires judgement by the reviewer at various stages of the process. The differences in underlying data and the need for judgement may create a degree of subjectivity of a comparability analysis.

26. The TPG provide that in cases where no one approach is conclusive, a flexible approach would allow the evidence of various methods to be used in conjunction.⁵¹
27. Some sources mention that a better understanding of the value creation, i.e. of the wider generation of value by the MNE group to which the tested party belongs, may contribute to increase the reliability of a comparability analysis⁵².

For discussion

Do you think further work should be done (in a separate work stream) on whether and how such an analysis of value creation may help to increase the reliability of a comparability analysis as a whole?

Do you have other suggestions to improve the reliability of the comparability analysis as a whole?

⁵¹ see par. 2.11 TPG

⁵² see par. 1.36 TPG