

January 2010

## *Proposed OECD Transfer Pricing Guidelines*

The OECD released for public comment a proposed revision of Chapters I-III of the Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations ("TPG"). This follows from the release in May 2006 of a discussion draft on comparability issues and in January 2008 of a discussion draft on transactional profit methods, and from discussions with commentators during a two-day consultation that was held in November 2008.

The main areas subject to new guidance are the arm's length itself, the comparability analysis, and the application of transitional net profits methods.

### **The arm's length principle**

The proposed draft discusses several reasons why OECD member countries and other countries have adopted the arm's length pricing, principal reason being that the arm's length principle provides broad parity of tax treatment for members of MNE groups and independent enterprises. Because the arm's length principle puts associated and independent enterprises on a more equal footing for tax purposes, it avoids the creation of tax advantages or disadvantages that would otherwise distort the relative competitive positions of either type of entity. In so removing these tax considerations from economic decisions, the arm's length principle promotes the growth of international trade and investment. Hence, OECD member countries continue to support strongly the arm's length principle. In fact, no legitimate or realistic alternative to the arm's length principle has emerged. Global formulary apportionment, sometimes mentioned as a possible alternative, would not be acceptable in theory, implementation, or practice.

In the existing TPG, there are two categories of OECD-recognized transfer pricing methods: the traditional transaction methods (described at Chapter II of the TPG) and the transactional profit methods (described at Chapter III). Transactional profit methods (the transactional net margin method and the profit split method) currently have a status of last resort methods, to be used only in the exceptional cases where there are no or insufficient data available to rely solely or at all on the traditional transaction methods. Based on the experience acquired in applying transactional profit methods since 1995, the OECD proposes removing exceptionality and replacing it with a standard whereby the selected transfer pricing method should be the "most appropriate method to the circumstances of the case". With the proposed regulations both the traditional transaction method and transactional profit method can be applied in an equally reliable manner, and method to be applied should be evaluated based on the circumstances of proposed transaction.

Moreover, MNE groups retain the freedom to apply methods not described in these Guidelines ("other methods") to establish prices provided those prices satisfy the arm's length principle in accordance with these Guidelines. Such other methods should however not be used in substitution for OECD recognized methods where the latter are appropriate to the facts and circumstances of the case. In cases where other methods are used, their selection should be supported by documentation including an explanation of why OECD-recognized methods were regarded as non-appropriate or non-workable in the circumstances of the case and of

the reason why the selected other method was regarded as providing a better solution. A taxpayer should maintain and be prepared to provide documentation regarding how its transfer prices were established.

### **Comparability analysis**

It is important to put the issue of comparability into perspective in order to emphasize the need for an approach that is balanced in terms of, on the one hand, its reliability and, on the other, the burden it creates for taxpayers and tax administrations.

The general guidance on the comparability analysis that is currently found at Chapter I of the TPG was updated and completed with a new Chapter III containing detailed proposed guidance on comparability analyses.

The OECD also recognizes that commercial databases featuring the trading results of companies are useful. The availability of only limited data does not preclude reliance on that data. There is an emphasis on the quality rather than the quantity of data. Further clarifications are presented on the interpretation of the arm's length range of results, use of multiple-year data and situations in which uncertain valuations exist from the outset, and how this might affect pricing between independent enterprises.

### **Guidance on the application of transactional profit methods**

Proposed additional guidance on the application of transactional profit methods was developed and included in Chapter II, new Part III.

For the profit split method, there is new guidance on the use of particular allocation keys—the use of assets and costs is discussed, along with the possibility of other potential keys such as incremental sales achieved, head counts, and time spent by employees.

The OECD states that the process for applying TNMM should not be less reliable than for other methods. However, good judgement should be accepted in case of a lack of available information. The OECD emphasizes the importance of considering the facts and circumstances of the case and illustrates the same with examples.

### **Conclusion**

The proposed changes will alter the structure of the existing Transfer Pricing Guidelines, as well as provide clarifications on the issues which previously may not be completely clear. Because transfer pricing is a high-risk area for tax administrations, it is essential that taxpayers be completely aware of the proposed changes and consider them carefully during implementation.

**Source:** OECD - Centre for Tax Policy and Administration

#### **Disclaimer:**

These materials and the information ("this information") contained herein are provided by KNAV and are intended to provide general information on a particular subject or subjects and are not an exhaustive treatment of such subject(s). This information is not intended to constitute accounting, tax, legal, investment, consulting, or other professional advice or services and should not be relied upon as the sole basis for any decision which may affect you or your business. . No reader should act on the basis of any information contained in this publication without considering and, if necessary, taking appropriate advice upon their own particular circumstances. None of KNAV, its member firms, or its and their respective affiliates shall be responsible for any loss and any special, indirect, incidental, consequential, or punitive damages or any other damages whatsoever whether in an action of contract, statute, tort (including, without limitation, negligence), or

otherwise, sustained by any person who relies on this information. If any of the foregoing is not fully enforceable for any reason, the remainder shall nonetheless continue to apply.

## **About KNAV**

KNAV is India's first multi-national firm of accountants and business advisors with operations in India, US and UK. We are currently expanding our operations to Canada, France & Netherlands. Our partners and professionals are qualified in various countries including India, US, Canada, UK and Ireland allowing us to provide you with seamless service across Asia, North America and Europe.