

Paris, 18 January 2010

Subject: Proposed Revision of Chapters I-III of the OECD Transfer Pricing Guidelines BIAC Comments

Dear Jeffrey,

Set forth below are the comments and recommendations of BIAC with regard to the 9 September 2009 document captioned "Proposed Revision of Chapters I-III of the Transfer Pricing Guidelines" (the "Proposed Revision").

We commend the OECD on the general quality and approach of the Proposed Revision. In its methodological approach and in material provisions it strikes a good balance between tax administration and commercial transfer pricing practices.

We specifically appreciate the opportunity to comment and continue our engagement on the most effective ways of improving the administration of transfer pricing globally through guidance on contemporary applications of the Arms' Length Principle. The spirit and details of our discussions in recent years on Comparability and Profit Methods reflect the need to update guidance in light of commercial and administrative practice developments.

Our paper is divided into two parts. This letter is the first part and covers some fundamental concerns that we have about the practical application of the concepts of comparability analysis and transfer pricing method selection. The second part is an Attachment to this letter and it sets forth several detailed suggestions regarding specific paragraphs in the Revised Proposal.

The Transfer Pricing Guidelines are very important to business and to tax authorities in that they can provide clarity for the practical applications of the Arm's Length Principle. However, we observe that since the time of the issuance of the Guidelines in 1995, disputes over transfer pricing have become more frequent and more intense. The 1995 Guidelines brought comprehensive guidance, but not always with sufficient detail or methodological base to reduce disputes and promote cross-border commerce through reliable tax administrative practices. In the area of transfer pricing it is critical to get both the concepts and the mechanics for applying those concepts right. By right mechanics we mean workable and practical methodologies for application of the concepts by taxpayers and authorities.

We are broadly pleased with the work on the concepts; our comments and recommendations herein are mostly around issues related to their implementation and are presented in the spirit of improvement and practicality. We appreciate the OECD's continuous efforts to establish international consensus on the administration and practical application of transfer pricing concepts.

We see the key aspects of the Proposed Revision as being: (i) change in the status of the transactional profit methods within the hierarchy of methods; (ii) additional guidance on the application of the transactional profit methods; and (iii) the addition of more detailed provisions on comparability analysis. For various reasons, the transactional profit methods have been in fact widely used in practice despite their status as a method of last resort in the 1995 Guidelines. The Proposed Revision is based on the recognition of this practice in fact. This is an important conceptual and administrative point, and we encourage that this practical approach be even more comprehensively applied in the Proposed Revision.

The overall re-structuring of Chapters I-III and the more comprehensive inclusion of guidance regarding methods and data are welcome. The structure and the emphasis bring more concreteness to the transfer pricing concepts and this concreteness (hopefully) will reduce the quantity and seeming randomness of various disputes in these areas. This will only occur, however, if the guidance can help deflect disputes caused by linguistic twisting of concepts (by all parties) that do not have firm methodology behind them.

To improve further the impact of the Guidelines, we emphasize the following structural and methodological concerns:

1. Compliance and documentation burden under comparability standard

Compliance and documentation burden remain major concerns for business not only in the Guidelines, but generally in OECD instruments and reports. Documentation is not the cure-all for tax administration that is implied in the many and regular invocations of it in OECD projects now; we need to take opportunities to be more cost and benefit focused regarding documentation. In this regard, language in the Proposed Revision around comparability analysis needs to be sharpened. The wording at paragraphs 3.80 and 3.81 was interpreted in different ways by BIAC members and we feel it is ambiguous on the subject of when an annual update of comparability analysis is required. Such updates are time-consuming and expensive, and current practice is not to update them annually. It would be preferable that the Proposed Revision clearly specifies a suggested practice on this point.

Recommendation: add in paragraphs 3.80-81:

“Annual updates of comparability analysis are not required unless there has been a material change in the circumstances of the transactions affecting their pricing. In the absence of such a change, the default should be a review on a three-year cycle not annually.”

Another area of difficulty in compliance burden that can arise under the Proposed Revision is lack of clear differentiation between what is meant to be illustrative and what is merely recommended in application of the comparability standard. Such a differentiation is doubly important for those countries that incorporate the Guidelines directly in their law.

Recommendation: There should be a statement at the front of the Guidelines to the effect that the guidance provides hints and tips and that the guidance is not intended to provide prescriptive rules appropriate to every case. The point of principle can be included in connection with such statement—that the goal is to determine what independent parties would have done in the same circumstances and that the process of comparison is only an imperfect way to approximate the behaviour of independent parties.

Consistent with this, paragraph 1.37 acknowledges that the extent to which the comparability factors are applicable or relevant depends on the circumstances. To make this paragraph more practical in application, it would be helpful if it included examples. *E.g.*, the paragraph could state that for transactions where there are readily available market benchmarks, including commodities, only two of the five comparability factors (characteristics of property and terms of contract) are relevant. Without such explicit guidance, it appears that all five factors always need to be analyzed. Even where there are sufficient benchmarks, there are often difficulties in determining contractual terms, product cycle, geographic markets, and business strategies of potential comparable companies--three of the five comparability factors. To some readers, failure to provide information about the majority of these factors is not interpreted as “some pieces of information being missing” as 1.38 states, but a flaw in the comparability analysis. Such interpretation could easily lead to unnecessary demands for additional work and disputes.

In general, we think that greater precision needs to be used in discussing the comparability factors to reflect that the discussion needs to set forth a practical and workable application of the concept. For further elaboration of the difficulties created by the over-extension of language see discussion of references to paragraphs 2.119, 2.121, 2.126, 2.136, 2.138, 2.134, 3.35 and 3.61 in the Attachment hereto. Also, to illustrate the possibility of mis-interpretation and unwieldy application of some of the language, we cite the discussion of contractual terms at 1.53 where it states that duration, geography, and exclusivity “can be assumed to be critical to assessing” comparability. It is not at all clear that such an assumption is correct, but in any event, the statement lends itself to open-ended demands for analysis that may be quite irrelevant under the circumstances.

2. Two key concepts may have ambiguous or circular applications in practice

There are two features of the Proposed Revision that we think require further work and detailed clarification. They relate to the methodological circularity that likely will arise from the use of the word ‘most’ (an absolute term) in conjunction with ‘appropriate’ and ‘reliable’ (relative terms). We ask that the methodology for selecting and confirming transfer pricing method and comparables be more technical and less a colloquial mixture of terms.

- “most appropriate method”

Regularly in the Proposed Revision the concept of ‘most appropriate’ is used to describe the transfer pricing method that must be used. In general, the Proposed Revision has successfully removed the stigma associated with “methods of last resort” and determined a hierarchy based on the degree of comparability and availability of information (paragraph 2.1). However, the “most appropriate method” requirement gives rise to the practical difficulty regarding extent to which analysis of other methods is needed. The statement in 2.1 that “the applicability of any particular method need not be disproved” is helpful but sits uncomfortably with the guidance at paragraphs 2.7 and 3.5 which implies that analysis is required of methods that are not selected. This is a key practical feature and it is left unclear in its application.

The use of the term “most” suggests that there could be a requirement to compare thoroughly the selected method to other methods. We believe it is sufficient to state the requirement as being “an appropriate method” rather than the “most appropriate method.” We believe that this wording is consistent with the guidance at paragraph 2.10, which states that the taxpayer is not required to “perform analyses under more than one method.” The guidance at paragraphs 3.57 and 3.58, which refers to situations where more than one method is used, can be read to contradict this helpful statement. We think that the Guidelines should be based on an objective standard of appropriateness, and not a free-ranging ‘most’ label that will result in circular debates.

Recommendation: The Proposed Revision should make it clear (paragraph 2.1 and similar locations) that where the taxpayer has used a method that meets the appropriateness threshold, then that method is to be followed unless the tax authorities show that such method is demonstrably not appropriate. Any other rule would be administratively burdensome, far too open-ended, imply a degree of perfection in this area that is impossible and would serve more as a “gotcha” review standard, rather than a rule of law.

Related to this issue about the procedure for determining appropriate method, we have concerns around the implications of the wording in paragraphs 2.110 to 2.117 and 2.150 (relating to strengths and weaknesses of the TNMM method). These paragraphs can be read to say that there is a higher threshold for appropriateness for TNMM compared with other methods. We believe that many of the concerns raised about the comparability standard for TNMM apply to all methods. As it stands, we see this section as effectively implying that TNMM remains a method of last resort, which we do not think is correct. **Suggestion:** These paragraphs of the Proposed Revision might better be incorporated into the discussion of general guidance of comparability in Chapter I, having applicability to all methods.

- “reasonably reliable comparables”

The concept of reliable comparables is central to the methodology of the Proposed Revision. Significant advancement has been made in the technical rationale for the concept and in practical applications. The key paragraphs are 3.2 and 3.3. We suggest some additional work be done on these paragraphs to avoid confusion on an important point.

Paragraphs 3.2 and 3.3 used the phrase ‘most reliable comparables’ and then strain to both describe what it means and to relate the phrase to the more practical, workable and relevant phrase ‘*reasonably* reliable comparables’. This drafting is problematic because it goes in circles linguistically and gives ambiguous guidance. The phrase ‘reasonably reliable comparables’ is used regularly in the Proposed Revision and it should be the standard. It is understandable and administrable. For further analysis of these points see the Attachment hereto under paragraphs 3.2 and 3.3.

Recommendation: We recommend that the following change to the Proposed Revision be made in order to ensure that a comparability analysis based on “reasonably reliable comparables”, as it is understood under the general meaning of the phrase, will be respected by tax authorities. This should apply even if additional comparables are subsequently found. Accordingly, we recommend that paragraph 3.3 be deleted and that paragraph 3.2 be revised to read as follows:

“3.2 As part of the process of selecting the appropriate transfer pricing method (see paragraph 2.1) and applying it, the comparability analysis always aims at finding reasonably reliable comparables. This does not mean that there is a requirement for an exhaustive search of all possible sources of comparables as it is acknowledged that there are limitations in availability of information and that searches for comparable data can be burdensome. See also discussion of compliance efforts at paragraphs 3.79-3.82. It should also be kept in mind that transfer pricing is not an exact science but does require the exercise of judgment (see paragraph 1.13).”

As noted, transfer pricing is not an exact science. It is virtually impossible to meet all comparability standards. As a result it is important to emphasize that the Guidelines should be viewed as indications as to what aspects to consider when performing and testing a search for comparables, rather than as a fixed set of absolutes that must be met. Normally, it is the taxpayer who provides with the first analysis of the transactions at hand. If he has presented a reasonable and sound analysis of those transactions and also, when selecting comparables, gave due consideration to the comparability factors, then the taxpayer has a justified expectation to be able to rely on that analysis and not to have it rejected simply because another method could have been used. This recommendation is a pragmatic and proportional way to articulate what constitutes sufficient effort by the taxpayer to base transfer prices on sound comparability analysis, given the facts and circumstances at hand.

Related to this, we suggest generally that more weight should be given to internal data and contribution analyses (including the so-called value-chain analysis), in circumstances where a profit split method is being applied. Such internal analyses could also be supported by having recourse to what is taught in price theory. So, for example, while in a bilateral oligopolistic market situation the bargaining power of the parties to a transaction will be pretty balanced, the bargaining power will be totally unbalanced if the market situation shows that one partner is operating in a fully competitive environment while the other enjoys a quasi monopolistic position. Further considerations on the comparability factor “Economic circumstances” would be helpful (e.g. elasticity of supply and demand depending on whether the goods are unique and of vital necessity or not or if there are equivalent substitute goods).

Such considerations help determine how expected total profits would have been allocated between independent third parties for the purposes of applying a profit split.

Suggestion: Where appropriate, internal data can be used, this should obviate the need for an exhaustive search for external data.

Going Forward

Putting our recommendations and comments in context, it is important to state that the Proposed Revision is a major accomplishment. Like many accomplishments, the Proposed Revision can always be improved, especially as to practical application, and we would welcome continued work on the points herein before publication.

The excellent work that has gone into revision of Chapters I to III indicates the value of regular reviews and updating of the Guidelines so as to keep pace with changes in transfer pricing practices, techniques and enforcement methods. Achieving ongoing conceptual, practical and methodological relevancy in transfer pricing is an ongoing challenge. This is especially the case now since the overriding goal of eliminating international double taxation cannot be achieved without further co-ordination with non-OECD member countries and that requires lucid and practical applications of the very important concepts set forth in the Guidelines. To achieve that, we recommend that review and revision of the Guidelines be carried out at least every 3 to 5 years.

We commend the OECD for the excellent work done.

Cordially,



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ATTACHMENT TO LETTER

Comments on Specific Paragraphs

Chapter I

Paragraph 1.7

We realise that the reference to “re-writing” of accounts is taken from paragraph 2 of the Commentary on Article 9, but it would be helpful if the full Commentary wording is added so that it is clear any “re-writing” of accounts is only “for the purposes of calculating tax liabilities of associated enterprises.” Such wording is helpfully retained at what was 2.3 and what is proposed to become 2.14, and should also be included in this introductory section.

Paragraph 1.38 Comparability: macro-analysis and industry standards

We propose to add in paragraph 1.38, a sentence regarding the importance of having macro-analysis in comparability analysis: for instance, “In selecting comparables, it is important to be mindful of the broader aspects of a controlled transaction. There may be cases when all the underlying facts and circumstances of a controlled transaction are carefully examined in a comprehensive manner, a controlled transaction may be comparable to an uncontrolled transaction that may have been viewed otherwise where only a microscopic analysis is conducted.”

We propose to add that where a certain industry standard exists in the industry to which the tested party belongs, such as an industry-standard royalty rate for the license to use manufacturing know-how, such industry standard should be taken into consideration in comparability analysis.

Paragraph 1.42: Functional analysis

The last sentence of the existing paragraph 1.20 states: “It will also be relevant to determine *in what juridical capacity* the taxpayer performs its functions.” This idea had been taken over from paragraph 17 (functional analysis) of the 1979 Transfer pricing Report: “it may be important not only to find out which entities perform the different functions ... but also to ascertain *in what capacity* they perform these functions – whether for example with regard to selling activities as principal (accepting all the risks and entitled to all the profits of the activity) or as agent (with limited risks and for limited return).” The recent OECD Report on the Attribution of profits to permanent establishments reconfirms in Part I, paragraph 21 (second sentence) the importance of the terms “in what capacity”. The term “juridical capacity” used in the 1995 Transfer Pricing Guidelines acknowledges the basic right of free choice of the entrepreneurial role (capacity) when performing functions and managing risks makes the relevant difference. This was meant to reconfirm the freedom of taxpayers to decide in their contracts what entrepreneurial roles they want to assume. This very

important statement would be lost if the new last sentence of paragraph 1.42 was left as it stands, which we think would be most unfortunate and inappropriate.

For these reasons we propose what follows:

The last sentence of paragraph 1.42 should be slightly modified and moved to the paragraphs dealing with “contractual terms” (1.51-1.53): **“It will also be relevant to determine the legal rights and obligations of the taxpayer deriving from the contractual terms.”**

The last sentence of old paragraph 1.20 must in our view be put back in the new paragraph 1.42, reading: **“It will also be relevant to determine in what juridical capacity the taxpayer performs its functions.”** Alternatively the term “juridical” might be deleted if this were more agreeable (although this would not be our preference), and the text would then read as follows: *“It will also be relevant to determine in what capacity the taxpayer performs its functions.”*

Paragraph 1.47: Functional analysis

The first sentence sounds somewhat odd. There is no need to say that the assumption of risks determines to some extent the allocation of risks between the parties ... We propose therefore to shorten the wording in brackets and just say: “... (taking into account the assets used) will determine to some extent the allocation of risks ...”

Paragraph 1.58: Business strategies

We feel this paragraph should reflect the fact that the business strategies of an enterprise may be either pro-active (for example new product development) or reactive (for example reflecting political changes or planned labour laws). Because of these different circumstances it may not always be clear which entities are responsible for creating and / or implementing certain parts of any strategy. Therefore we suggest that the final sentence of this paragraph, considering which group members will devise and / or implement business strategies, should be reconsidered.

Paragraphs 1.63 – 1.68: Recognition of the actual transactions undertaken

We are missing a clear statement saying that non-recognition of actual transactions begins where the discrepancy between substance and form is so important that such discrepancy cannot be reliably eliminated through a comparability analysis and appropriate adjustments. Pursuant to this, we wonder if in the first example given in paragraph 1.64 (thin capitalization) the non-recognition of interest deductions is not closer to a comparability adjustment than to a restructuring or a non-recognition of the transaction. More examples would be helpful.

Paragraph 1.64 Specifically

The discussion of the recognition of actual transactions undertaken should be consistent with similar discussions in the Consultation Document on Transfer Pricing Aspects of Business Restructuring. That discussion acknowledges the relevance of group-level business reasons when considering commercial rationality, and that approach should be reflected here. In particular wording such as that found in paragraph 208 of that Document should be incorporated here: "Tax administrations should not ordinarily interfere with the business decisions of a taxpayer as to how to structure its business arrangements. A determination that a controlled transaction is not commercially rational must therefore be made with great caution, and only in exceptional circumstances lead to the non-recognition of the related party arrangements. In circumstances where reliable data show that similar transactions or arrangements exist between independent parties, it cannot be argued that such an arrangement between related parties would lack commercial rationality."

Paragraph 1.69 Losses

The following sentence in paragraph 1.69 addresses the cases where an MNE group as a whole is profitable: "When an associated enterprise consistently realizes losses while the MNE group as a whole is profitable, the facts could trigger some special scrutiny of transfer pricing issues." However, this paragraph or section does not consider instances when an MNE group, as a whole, incurs a loss. As such, we propose to add a paragraph in this section that discusses the impact on transfer pricing analysis of a related party belonging to an MNE group that as a whole incurs a loss.

Chapter I General: Government policies and placement of global formulary appointment discussion

We propose to add the following to the section for the effect of government policies, for clearer guidance: "In a situation where there are government interventions, there may be cases where there are no comparable transactions, or where it is not possible to make adjustments to potentially comparable transactions. In such cases, in principle, government interventions should be considered as given in setting transfer prices, and any distortion as a result of such interventions should be treated as unavoidable."

In the proposed revision, the section on global formulary appointment is moved to "C. A non-arm's-length approach: global formulary apportionment" (Chapter I). However, it seems odd to have a section non-arm's length approaches before the provisions on the arm's length transfer pricing methods/approaches are discussed. Therefore, we propose to place these provisions after "D. Conclusions on transactional profit methods" (Chapter II) as in the current guidelines.

Chapter II

Paragraph 2.3

The discussion of appropriateness in Paragraph 2.3 is not very helpful and can be misleading. Where there are “material differences in functions between the tested and uncontrolled transaction which are reflected only in operating expenses below the gross margin level”, it is not clear why you cannot adjust a RPM or Cost Plus Method instead of going to a TNMM. Such a formulation could discourage consideration of RPM or Cost Plus Method. Also, the reference to “unique intangibles” is not helpful since the phrase is too vague and could lead to unnecessary questioning of the reliability of a traditional transaction method or TNMM. What is probably meant here are significant intangibles which are not found in uncontrolled arrangements?

Paragraph 2.11

The concept of a corroborating method at 2.11 is unhelpful since no link is made with the discussion of difficult cases in 2.10. As it stands, 2.11 may give the impression that a corroborating method is generally to be considered, and it is unclear how a secondary method might indicate the primary method is not the most appropriate, and what one is then supposed to do. The detailed guidance on comparability may tend to give the impression that application of any method is difficult in practice, and that a corroborating method is required.

Paragraph 2.69

In paragraph 2.63, it is recommended to apply the transactional profit split method in cases where both parties to a transaction contribute ‘unique’ intangibles. While we appreciate this guidance, it is desirable to have further clarification regarding the distinction between ‘unique’ and ‘non-unique’ intangibles.

Paragraph 2.73 Contribution analysis

In paragraph 2.73, it provides that in the absence of comparable data, “it [the division of profits] is often based on the relative value of the functions performed by each of the associated enterprises participating in the controlled transactions, taking account of their assets used and risks assumed.” This description could be viewed as a global formulary approach: in order to further clarify, we propose to add the following sentence:

“To be clear, it should be noted that such contribution analysis is different from a global formulary apportionment approach.”

In addition, we suggest that the OECD should seek to strengthen the statement that contribution analysis should be supported by economically appropriate data, providing evidence on how third parties would approach a profit split arrangement in the same circumstances.

Paragraph 2.79

The Guidelines state at 2.79 that both parties have to prepare accounts on the same basis. However, profit splits may be very simple calculations of the profit of a particular transaction and third parties may define how this is calculated without having to draw up detailed set of accounts. Similarly, accounting standards may not be relevant, and indeed it may be impossible to ensure that they are “applied consistently over the lifetime of the arrangement” since standards change. The guidance should allow for circumstances where the parties agree the appropriate financial data and measurement criteria. In the same vein, financial accounting may not always be the starting point for determining the profit to be split (2.80). Often it is the contractual pricing arrangements between the parties which would determine this.

Paragraph 2.88

Regarding allocation keys, we have reservations about the reference to keys based on assets / capital or costs as ‘the most common’, on the grounds that it these keys should not become perceived as default options. We suggest instead describing them as ‘often used’.

Paragraph 2.91

The reference to cost-based allocation keys at 2.91 is confusing in its drafting since it appears to relate to only one party. Presumably the reference to “a distributor-marketer” and “a manufacturer” should be changed to “two or more distributor-marketers” or “two or more manufacturers.” In addition, the costs should relate to costs borne by the parties, and not recharged to other parties.

Paragraph 2.92

With regard to use of cost-based factors in applying the transactional profit split method, it is desirable to have more guidance by including a description of adjustment mechanisms that could be used to address different levels of costs (e.g., differentials in wages, etc.), in paragraph 2.92.

Paragraph 2.94

The discussion of third-party arrangements which may help in splitting profits for the purpose of the profit split method at 2.94 is not correct. For example, the Guidelines identify licence agreements as a potential comparable for the profit split method. However, licence agreements are a measure of what the licensee pays the licensor, it provides no information on the profit of the licensor or how the overall profits are split. A conventional profit split would seek to split the combined profits of the two parties: a licence fee is only a “split” of the licensee’s profits. Unless these are internal CUPs it will not be known how the licence fee splits the overall profits.

Paragraph 2.101

What is a one-sided method? Paragraph 2.101 suggests that all methods except profit splits are one-sided methods, whereas 3.20 leaves out the CUP as a one-sided method. A CUP would seem to be a two-sided method since the price would be expected to be the same whether tested from the perspective of buyer or seller.

We agree with the underlying principles described in paragraph 2.101 and 3.18, that the transactional net margin method is recommended where one of the parties performs less complex functions without making any unique contribution.

However, in cases where there are combined losses, a situation oftentimes referred to as “income creation” may occur when allocating a certain amount of profit to one of the parties through application of the transactional net margin method.

Therefore, we propose to add a paragraph stating that in case of combined losses, causes for the combined losses should be thoroughly analyzed and, where appropriate, the transactional net margin method should be applied with more flexibility by taking into account of the overall allocation of combined loss among the related parties.

Paragraphs 2.104 and 2.112

It is difficult without a lot of effort to square 2.104 and 2.112. The first seems to say that net margins (probably mean net profits) are less affected by transactional differences than gross margins (probably mean gross profits), whereas the second seems to say that net profits are more volatile than gross profits. The examples in Annex II: Sensitivity of Gross and Net Profit Margin Indicators highlight comparability issues in theory which are unlikely to be easily identifiable in practice; for example, information about the factory utilisation of comparables is unlikely to be publicly available. It is not clear what the point of the examples might be, other than to suggest that comparability is very difficult. The examples do not help determine whether a gross margin or a net margin is more appropriate because they depend on information being available about comparables to an extent rarely encountered in practice. It is interesting to note that Illustration 1 can be used to review the appropriateness of Berry Ratios. Under Case 1 the Berry Ratio is (400 to 350) 1.14, and under Case 2 it is (520:450) 1.15. It appears that the close correlation between functional costs and reward is supportive of measures like the Berry Ratio for distributors, and a reference could be added at 2.141.

Paragraphs 2.119 et seq

Given the discussion of various Profit Level Indicators, the Transactional Net Margin Method should now be re-named the Transactional Net Profit Method. Net margin is then one of the PLIs that can be used under this method. The Proposed Revision does confuse net margin (net profit weighted against sales) and net profit in many references (particularly from 2.119 to 139—for example, one cannot have a net profit margin as a return on investment as recommended in 2.127), and it is recommended that these confusions are removed in the revised version.

Segmentation seems to be required by 2.119, but this can be very expensive to perform, and should not be considered to be required in all cases.

The use of EBIT as the apparently recommended measure of profit at 2.121 is surprising. There is a difference between operating profit and EBIT. EBIT is not commonly used as a measure of net profit for transfer pricing purposes. EBIT can include exceptional items which do not relate to the day-to-day trading operations. Operating profit is commonly used to calculate net profit.

Paragraph 2.126

The intention of the following sentence in paragraph 2.126, prescribing the treatment of start-up and termination costs, is unclear: “One factor that is likely to affect this determination is whether the activity is performed by the taxpayer for the exclusive benefit of one related party, or whether the taxpayer also has other (related or unrelated) customers for this activity (see also guidance on business strategies at paragraphs 1.58-1.62).”. We propose to delete this sentence from this proposed revision as it may oversimplify this complex issue for which more discussions may be warranted.

Discussion of inclusion of start-up costs or termination costs in the net profit margin (2.126) is unhelpful since the conclusion seems to be that the costs should be passed on with a mark-up if the party operates for the exclusive benefit of one related party. This comment is likely to be read as prescriptive; whereas the determination should be made by reference to arm’s length criteria.

Paragraph 2.128 et al Choice of PLIs

While it is useful to have more PLIs explicitly endorsed than in the current Guidelines (including Berry ratios), the Proposed Revision appears to prescribe certain PLIs for certain circumstances. However, a return on capital is a different measure to cost-plus, and the two ratios measure different things, but it is not self-evident that the former is more appropriate to “certain manufacturing activities” than the other (2.127). Indeed, 2.128 then appears to contradict the advice by stating that cost plus may be appropriate for a manufacturing activity. It is also unclear what the “significant risk due to the significance of the investments” might be where operational risks are limited. If there is a manufacturing service fee which covers the cost of investment, then the investment risk is reduced. The guidance either needs to make it clear that various PLIs can be used without specifying when they might be useful or the guidance needs to be extended. The various PLIs commonly used are different ways of capturing business performance and efficiency, and differences in ratios between the tested party and comparable independent companies can be instructive in indicating potential differences in functions and the associated sales, cost or asset base. However, PLIs do use different inputs, and conceptually, it is relevant to consider the appropriateness of those inputs in measuring relative business performance. For example, if the functions of a party require a very low working capital base, then any measure taking working capital as its denominator may not be very informative about business performance in absolute terms,

and may give rise to significant variations when comparing with businesses with higher (even slightly higher) denominators. The preference is for the guidance on PLIs to be illustrative only so that the limited references to other PLIs in the 1995 Guidelines is extended, but enabling the taxpayer to use an appropriate PLI without having to prove or disprove application of the PLI.

Paragraph 2.129

Paragraph 2.129 provides that the denominator in the calculation of net profit margin indicator should be reasonably independent from controlled transactions. However, there are cases where related-party costs need to be included in the denominator: for example, for a contract manufacturer as a tested party where total cost is chosen as the denominator, the total cost may need to include the cost of materials imported from related party, after adjusting it to an arm's length price. As such, to address such cases, we propose to add the following sentence at the end of Paragraph 2.129.

“However, where the denominator is not independent from controlled transactions, it can be still used if the prices of the controlled transactions have been adjusted in accordance with the arm's length principle.

Paragraph 2.131: Cases where the net profit is weighted to sales

We doubt if the term “sometimes” in the first sentence is appropriate. Indeed when applying the TNMM to a distributor, tax authorities *frequently* weight the net profit to sales.

Paragraph 2.134 Pass-through Costs

Pass-through costs are discussed at 2.134 and 135. The discussion seems to conclude that if an independent party would not expect to be remunerated by reference to such costs, then they can be treated as pass-through. We agree with this conclusion. But then the guidance requires an adjustment to the cost-base of the comparables, which is difficult in practice, and it appears that the determination of these costs as pass-through would be reversed. Is this meant to be the conclusion?

Additionally, in applying the functional and comparability analysis called for in this paragraph, we suggest that reference be made to Paragraph 7.36 which sets forth details of handling agents and intermediaries and which we think is analogous to the pass-through situations.

Paragraph 2.136

The discussion of budgeted versus actual costs remains confused at 2.136. The discussion seems to suggest that using actual costs is less arm's length, but it confuses setting and testing transfer pricing (and the Proposed Revision should be focusing on testing). The discussion also ignores the issue of different risk profile arising from whether the tested party bears the risk of cost overruns. External benchmarks inevitably will be based on the actual outturn.

Paragraph 2.137-2.138: Cases where the net profit is weighted to assets

Experience shows that this approach raises considerable comparability issues in order to determine the appropriate return on assets or capital employed. The lifetime of the fixed assets may in such cases strongly vary depending on the nature of the asset-intensive manufacturing activity. An arm's length rate of return might only be appropriate if it could be applied on the long-term average book (or possibly market) value of the fixed assets. The fact that such value will be extremely high in the initial phase of the enterprise, probably fair in its middle phase and certainly insufficient in its final phase will in any fiscal year hardly produce a realistic result. Modifying the rate of return according to the age of the fixed assets might temporarily be a solution but there is always a risk that at one moment in the lifetime of the manufacturer the link between the market value of its production and its taxable profit gets totally lost. Therefore, we think that these cases should be handled with caution and that their taxable results should be regularly tested by means of more than one method.

In cases involving a tested party performing both manufacturing and distribution functions, combining profits based on a return on assets for the respective functions may be an appropriate measure, rather than combining profits based on a return on costs and a return on sales for the respective functions. This is because the use of a return on assets may eliminate potential distortions caused by the controlled transactions. It is desirable to include a reference to such a case into paragraph 2.137 as an example case where the return on assets can be appropriate.

In the proposed revision, "a return on sales", "a return on costs", and "a return on assets" are clearly introduced as potential net profit margin indicators when applying the transactional net margin method. However, there is no clear description of "a return on capital". It is only referred briefly in paragraph 2.137, which is related to the return on assets. The use of other profit level indicators should be limited (see paragraph 2.138), and it is not necessarily clear about the use of a return on capital.

There are cases in the financial services industry where a return on capital could be the most appropriate net profit margin indicator. Therefore, we propose to add the following sentence, for clarification, at the end of paragraph 2.137.

"In the financial services industry, a return on capital is sometimes used as the net profit margin indicator. "

How to value assets in an asset-based PLI is made unclear at 2.138. If the paragraph is intending to suggest that one needs to perform a valuation of assets when using an asset-based PLI, then this is very unhelpful.

Paragraphs 2.140-2.142: Berry ratios

It should not be given the impression that a Berry ratio is something different than a TNMM where the net margin is weighted to distribution operating expenses. The Berry ratio therefore carries in itself all the weaknesses of the cost plus method, and in particular the inherent risk to penalize efficiency (low costs, high sales) and to offer a premium to inefficiency (high costs, modest sales).

Chapter III

Paragraphs 3.2 and 3.3

Paragraph 3.2 and 3.3 in the Proposed Revision read as follows:

“3.2 As part of the process of selecting the most appropriate transfer pricing method (see paragraph 2.1) and applying it, the comparability analysis always aims at finding the most reliable comparables. This does not mean that there is a requirement for an exhaustive search of all possible sources of comparables as it is acknowledged that there are limitations in availability of information and that searches for comparables data can be burdensome. See also discussion of compliance efforts at paragraphs 3.79-3.82. For this reason, the phrase “reasonably reliable comparables” is used in these Guidelines to refer to the most reliable comparables in the circumstances of the case, keeping in mind the above limitations.

3.3 This does not, however, imply a safe harbour. The fact that reasonable efforts have been made in finding and selecting comparables cannot rule out the possibility that more reliable comparables data may ultimately be found and used in determining an arm’s length outcome.”

The expression “reasonably reliable comparables” can be found in at least 18 paragraphs in the Proposed Revision Guidelines (1.13, 1.38, 1.53, 2.1, 2.3, 2.62, 2.64, 2.73, 2.86, 2.139, 2.144, 3.2, 3.29, 3.31, 3.34, 3.36, 3.37, 3.80).

First of all, it seems odd to give a term, which is used so many times throughout the entire document, a meaning other than the general meaning of the term. In general, it is difficult to argue that “reasonably reliable” has the same meaning as “the most reliable”.

Secondly, if comparables are found to be “reasonably reliable” (disregarding the definition proposed in paragraph 3.2) it is hard to understand why or how these comparables disqualify as “reasonably reliable” only because “more reliable” comparables are found. An outcome based on “reasonably reliable comparables” (again disregarding the definition proposed in paragraph 3.2) should be acceptable even if “more reliable comparables” are subsequently found. The proposed definition in paragraph 3.2 creates a “circular reasoning” making it virtually impossible to know whether “reasonably reliable comparables” (meaning “the most reliable comparables”) have been found and used. This results in an unacceptable high degree of uncertainty for taxpayers.

Furthermore, paragraphs 3.2 and 3.3 send a strange message to taxpayers. From paragraph 3.3 it follows that the use of reasonably reliable comparables does not imply a safe harbour. It seems strange to impose a requirement for the use of the most reliable comparables and then state that even if the most reliable comparables are used, an adjustment can be made. Can there be any more reliable comparables than the most reliable comparables? If not, then why does the use of the most reliable comparables not create a safe harbour?

Paragraphs 3.2 and 3.3 could be understood as stating that even if a taxpayer applies and follows the Guidelines, uses reasonably reliable comparables and arrives at an outcome that is reasonably accurate, the taxpayer can still be subject to an adjustment. This could effectively undermine the status of the Guidelines. Why follow the Guidelines if there is no benefit in doing so?

The reasoning in 3.3 also stands in contrast with the spirit of the wording in other parts of the Guidelines;

- 1.13: “/.../ It should also be recalled at this point that transfer pricing is not an exact science but does require the exercise of judgement on the part of both the tax administration and taxpayer.”
- 3.54: “/.../ transfer pricing is not an exact science /.../”
- 2.110: “/.../ Determining a reliable estimate of an arm’s length outcome requires flexibility and the exercise of good judgment /.../”

Finally, it is hard to understand the logic in having a statement requiring the use of “the most reliable comparables” while at the same time stating that there is no requirement for an exhaustive search of all possible sources of information.

Considering that transfer pricing is a core issue for companies, the need for predictability and clear guidance in this area is essential. Without it the risk of unresolved double taxation in many cases is obvious.

For these reasons, we propose a revision of the Proposed Revision set forth in our letter above.

Paragraphs 3.30-3.33: Databases

In our view, the recourse to databases as an assessment technique should remain only a sanity approach, which should be clearly stated in paragraphs 3.30-3.33.

Also, the statement in 3.32 that quantity should not be encouraged over quality is a sound statement. However, it needs to be recognized that generally there are no perfect comparables available and hence Tax Administrations should use caution when questioning comparables used by the tax payers if these have been selected in good faith following an appropriate analysis. Statements emphasizing that the same prudent behaviour, when selecting and reviewing comparables, need to be observed by tax administrations would be welcomed. It is e.g. rare that an analysis made by tax administrations is transparent, systematic and repeatable. However, it is not rare that a tax administration challenges a "best effort analysis" (which should be seen in the light of the fact that transfer pricing is not an exact science and it is very rare that, following a comparability study, including functional analysis, perfect comparables exist) prepared by a taxpayer by simply "rejecting" the use of certain comparables.

Paragraph 3.35 Secret comparables

The discussion of secret comparables at 3.35 loses part of old 3.30 so that it gives the impression that secret comparables are allowed as long as they can be disclosed to the taxpayer. This ignores the fact that the taxpayer could not have known about such data when performing their own analysis. Unless the information is in the public domain, it is inappropriate to use such data.

We propose to add the following sentence at the end of paragraph 3.35:

“In principle, the information that is not available to the taxpayer through the public domain should not be used.”

3.46 Comparability adjustments

With regard to the comparability adjustments generally, we recommend that there be added guidance on the interaction between the degree of differences and the necessity of adjustments to reconcile these differences, and also on suggested methods that could be used to make these adjustments (aside from differences in working capital).

Paragraphs 3.47-3.48: Different types of comparability adjustments

In practice one has to face different types of balance sheet and P&L adjustments. The working capital adjustment as illustrated in Annex III to Chapter III is a welcome clarification. However, in practice, even if such adjustments are made, they hardly have a significant impact on the result of a MAP or an APA. It would therefore be a positive message if OECD could take the commitment to further explore adjustment techniques, notably with the aim to explaining why plain cost adjustments, i.e. without inclusion of a risk/profit element associated with productive expenditure, may often produce flawed comparability adjustments (e.g. in cases where R&D expenditures vary strongly between the comparables and the taxpayer).

Paragraphs 3.56 and 3.60/3.61: Arm's length range + paragraph 3.78: Multiple year data

While it may not be fully satisfactory to automatically adjust to the lowest or the highest point of an agreed range where no point within the range can be identified as best reflecting the facts and circumstances of the particular controlled transaction, we hesitate to support the use of statistical techniques. Once more we would like to draw the attention on the danger to transform the arm's length principle into a purely mathematical exercise giving the impression that doing so the result will be scientifically correct, although it is well-known that transfer pricing is not an exact science. While ranges should be used as plausibility tests, the simple or weighted average, the median and also the most frequent value (mode) within the range are likely to produce arbitrary results. If an agreement can be reached on what should be an inter-quartile range, why depart from the practical solution that consists in referring either to the lowest or the highest point of such an inter-quartile range where the reported results are outside such range?

Under the proposed changes in the Guidelines, if not all observations are equally reliable, this may call for a need to consider the use of statistical tools (e.g. inter-quartile) to improve reliability. If all observations are reliable, the use of the full range seems appropriate. However, according to the new 3.61, it may be appropriate to use measures of central tendency (median) in determining the point to which an adjustment (by the tax administration) is made where comparability defects remain. This statement seems to be contradictory to the ALP. Why would a central tendency be more appropriate than any other point in the range (and specifically a point within the range that better reflect the actual result of the taxpayer)? We believe that this statement could be used by several tax administrations to routinely make adjustments to the median rather than another point in the range (upper or lower end of the range), which would be highly negative for the business community, not to say contradictory to the principles established in the Guidelines. This would also make the MAP more difficult. Such an outcome is unacceptable.

The meaning of “central tendency” is unclear. Paragraph 3.61 seems to be suggesting that where adjustments are required, they should be made to median of range. This needs to be clarified since it is not standard practice. Paragraph 3.56 seems to have different definitions of “central tendency,” apparently including any percentile.

Paragraphs 3.69 and 3.70: Timing of collection

While we understand that tax authorities have often no alternative but to apply the arm’s length outcome-testing approach, we think that this approach raises the same sort of concerns as the ex post profit split approach. A clear reservation should be introduced in the text against the use of hindsight.

The fact that the arm's length outcome testing approach (3.69) would rarely be applied between third parties does not seem to be acknowledged in the Guidelines. In addition, to the extent year-end adjustments (or compensatory adjustments) are performed before year-end closing rather than after year end closing, in connection with the tax return submission, this would in many cases increase the possibility for taxpayer to account for this adjustment on the other side of the transaction rather than resorting to the MAP. This would be beneficial to both taxpayer and tax administrations. We believe this is worth emphasizing since the statements in 3.69 seem entirely focused on adjustments in connection with preparing the tax return.

Paragraph 3.72

The language suggested in 3.72 in relation to “ex post” adjustments is very welcome and could actually serve as a model for a more general guidance in this context.

Annexes II and III to Chapter II, Part III

We do not feel that these examples are necessary and due to possible misunderstandings we also feel they may be unhelpful. We would suggest these examples are removed. If they are retained, we would suggest that the following changes should be made.

Annex II (Illustration 1; paragraph 3)

While we understand the aim of the message given by Illustration 1, we think that if case 2 should really show a situation between related parties (important gross margin) and case 1 a situation between unrelated parties (lower gross margin) the conclusion would be that the related party reported excessive profit; this should be clearly said because Illustrations 2 and 3 show reverse situations. The use of the TNMM would obviously in all illustrations mitigate the risk of error.

Annex III (paragraph 8; second bullet point)

It would help the reader if an explanation was given on the reason why “a lending rate may be considered” when $\text{Payables} > \text{Receivables} + \text{Inventory}$.