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Introduction

The following sets forth a compilation of responses from members of BIAC to the questions as asked. Each response is structured to have a summary of BIAC members' experiences with the subject matter of the issue, followed by suggestions for improvement. The BIAC compilation includes commentary from several of its members who also separately submitted their comments to the OECD.

There are some overarching themes to the BIAC comments that should be highlighted, and they call into question the fundamentals of the approach implied in the questions. The practices of dealing with transfer pricing reported by the members indicate that the concepts of the 1995 Guidelines are not as accessible a means of delivering arm's length results as was intended. The questions in this survey indicate a desire to implement incremental changes to the mechanics to reach better results, but we submit that the issue should be thought of in broader terms -- of understanding the relationship between evidence of commercial practices and demonstrating arm's length results. We believe that it is not appropriate merely to work from the current mechanics of comparability, but rather to focus on developing a more thorough understanding of the relevant data and its collection. In this regard it is appropriate to state the common goal for tax administration and for companies under the arms length standard, of having a structure of inter-company pricing arrangements for a company and its products and services that are reasonably comparable to third party arrangements. The focus then should be on the companies building their pricing arrangements from their commercial practices and the taxing authority assessing the reasonableness of the pricing arrangements, both in light of available data.

Another theme relates to the development of methods of approximation when the pure data is unavailable. Absence of data is identified as a persistent problem. The challenge is to work from the available data to reach a reasoned approximation of arm's length. From the questions, this would not seem to be high on the agenda yet of WP No. 6 and we think that it should be.

Issue: COMP 1 – Requirement to perform an analysis of transactions *vs. an analysis of third party information gathered at company level*

BIAC members report that in practice, it is highly unusual to find publicly available data at the transactional level. Although data availability varies from jurisdiction to jurisdiction, reliable data on prices set in respect of a transaction, or even margins earned on a particular transaction flow, is rarely found.

We submit that under certain circumstances third party data at company level can be used to support the arm's length standard. We recognise, however, the limitations of publicly available data at company level and the effect such limitations may have on the transactional approach advocated by the OECD. However, a degree of comparability at the company level can be obtained by applying objective screening measures. For example, where a company performs one major function (e.g. routine distribution), i.e. it is not diversified or integrated in its activities, the company's overall results can be used to benchmark the

distribution function performed by an multinational enterprise ("MNE") in a related party transaction. In addition, given objective screening measures, data at company level may be preferable where the tested party's transactions need to be bundled into functional related baskets or because the separate transactions are highly interrelated. For example, a product may be sold with after sale services attached to the transaction (often referred to as the "razor and blade" issue). Benchmarking the sale of the product separately from the sale of the after sale services may, in certain circumstances, not be appropriate or reliable. In such cases, the results at company level may be more appropriate and margins earned on the bundled transactions may need to be analysed.

Given the experiences above we submit that the current wording of paragraph 1.42 in the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations ("OECD Guidelines") is too restrictive and should be reviewed. Amendments to paragraph 1.42 are particularly warranted as certain tax authorities have rejected the use of company-wide data outright on the basis of the aforementioned paragraph.

EXAMPLES:

- As previously mentioned: a company performs one major function, e.g. routine distribution. The results at company level may be used as a reliable measure to analyse the arm's length nature of the tested party's distribution function.

- The tested party sells certain products in finished form for which it also performs a marketing function. However, the same tested party performs some secondary manufacturing for other products. In this case, it may be appropriate to bundle the distribution of all finished products for which marketing is performed and determine whether the arm's length principle has been adhered to by analysing the results at company level of entities that perform distribution and marketing functions. The secondary manufacturing function may then need to be benchmarked separately.

Issue: COMP 2 – Need to rely on transactions that took place between independent enterprises

BIAC members acknowledge that, when trying to establish a set of comparable companies, the inclusion of information on third party enterprises engaged in controlled transactions is not a literal application of the arm's length standard. However, members also indicate that in their experience, due to the lack of available information, under certain circumstances the consolidated results of the MNE can constitute a viable benchmark and an approximation of arm's length behaviour for related party transactions. BIAC believes that paragraph 1.70 should be amended to reflect this experience. Rejection by fiat of data from controlled transactions is too rigid and impractical.

For example, where an MNE is comprised of trading entities that perform functions and assume risks that are broadly comparable to the tested party, the **consolidated** accounts of such MNE should not be rejected outright as they may provide a reasonable approximation of an arm's length return.

Another example could be where the level of related party transactions within a MNE is not substantial. As minimal levels of intra-group activity should not significantly influence the results of a company, such information may provide a reasonable approximation of an arm's length outcome. A further example can be found in Asian countries where MNEs operate along the *keiretsu* model and where information on truly independent enterprises is scarce.

Based on the comments above, we submit that paragraph 1.70 of the OECD Guidelines should be amended to take into account that in certain circumstances where reliable third party information is not

available, the (consolidated) accounts of an MNE may provide a viable indication of arm's length behaviour.

EXAMPLES:

- The ultimate holding company is a "shell" company, holding shares in several distribution entities. The activities of these distribution entities may, in certain cases, be comparable to the functions performed and risks assumed of the tested party. By analysing the consolidated accounts, i.e. at the level of the ultimate holding company, potential transfer pricing issues are cancelled out and such accounts may provide a valid arm's length benchmark.

- A European pharmaceutical company applied an interquartile range of returns on sales published by 20 comparable affiliated companies. This set of comparable, though not truly independent, companies was accepted by the relevant local tax authority.

Issue: COMP 3 – Need to obtain third party information relevant to the review of the five comparability factors

We find that the BIAC members support the five-factor approach, but because of lack of comparable data, conclude that it rarely can be fully used in practice. In certain markets, such as the US where a more detailed disclosure of company information is required, sufficient information on the transactions and on the industry companies operate in may be available to enable the transfer pricing analyst to review a potential comparable company with regards to the five comparability factors. However, in the majority of cases, extensive qualitative information will not be publicly available and an explicit review of the five comparability factors discussed in paragraphs 1.19 to 1.35 is rendered impossible.

Notwithstanding the above, a **consistently applied** and **objectively determined** search strategy can ensure that the closest possible comparability between tested party and selected comparable companies is achieved. For example, in addition to preliminary quantitative screens, a review of available business descriptions can ensure that companies performing widely dissimilar functions are rejected as potentially comparable companies.

Although additional information may be available from a wide range of alternative sources, tax authorities should be conscious of the additional compliance burden the analysis of all available sources may impose on the taxpayer. A cost benefit analysis should be advocated by the OECD so that taxpayers with a relatively low level of cross border, related party transactions are not required to explore every possible source of information. In certain de minimis cases, the cost of analysing all available sources may outweigh the potential transfer pricing liability to the taxpayer and reliance on data available in databases compiled by third party service providers (e.g. Bureau van Dijk) should suffice.

EXAMPLE:

- The Australian Taxation Office ("ATO") has included a de minimis case in its Taxation Ruling 1999/1 "Income tax: international transfer pricing for intra-group services". This ruling mentions in paragraph 77 that "where the costs of all intra-group services supplied or acquired are relatively small, the Commissioner will not adjust prices that are within a specified range. In the de minimis case, the adjustments that may be forgone are not considered to be material enough to warrant the extra compliance and/or administrative effort required to establish more precisely the arm's length price for the services." In addition, the ATO has lowered the compliance burden for small taxpayers by

absolving those taxpayers from submitting a specific transfer pricing related tax form, i.e. the Schedule 25A, when the amount of international related party transactions does not exceed AUD1 million.

- One of our constituents has responded to the survey with its list of indirect indicators, which we repeat here for emphasis. This illustrates in a specific industry the sort of factors that are used by the taxpayer to develop a relevant commercial frame for assessing transfer pricing practices. It is not exhaustive nor necessarily applicable to other industries, but is indicative.

- For transfer price negotiations for individual products the following indirect indicators have been successfully used to arrive at an appropriate product margin:
  - weight of the individual product in the basket of products
  - type of competitive market each product is in
  - innovation of the product (i.e. different degree of R&D contribution)
  - manufacturing intensity or difficulty
  - relevance in the volume of all inter-company purchases
  - age of the product (date of introduction to the market)
  - selling price erosion since the introduction to the market
  - exposure to future discounts
  - marketing intensity over time

Issue: COMP 4 – Need to ensure objectivity of the list of external comparables

It is recognised that a certain degree of subjectivity may enter into a search process. However, as mentioned in "COMP 3" above, a consistently applied and objectively determined search strategy should avoid "cherry picking" of potentially comparable companies. Such a consistently applied and objectively determined search strategy can be evidenced by recording and documenting the reasons for excluding potentially comparable companies.

In addition to the above, due to limitations on data that is publicly available, a re-focusing of the application of the comparability criteria may be required in order to arrive at a set of comparable companies large enough to draw statistical inferences from. The goal is assessment of the reasonableness of pricing arrangements and this is not an exact science. This important issue is further elaborated under "COMP 8" below.

Issue: COMP 5 – Determination of the years to be covered and use of multiple year data

BIAC members report that, as noted, in practice, only historical data is publicly available regarding third party matters. Historical data is used to help build as relevant a pricing frame as practical for the taxpayer. This frame, objectively determined and consistently applied, by the taxpayer is the most reliable basis for the applicable period. Members believe that the concept of potential adjustments is contrary to taxpayer-developed practices and is applied too rigidly and conveniently by the tax authorities. It is therefore submitted that specific guidance on potential adjustments to take into account the historical nature of the data available is undesirable as it is unlikely that such adjustments would produce any more reliable results.

From a theoretical perspective, the number of years of data considered should ideally cover the economic cycle of the industry in question. However, such business cycles may be hard to define and not all comparable companies selected may be in the same phase of the business cycle as the tested party. It is therefore submitted that the OECD Guidelines should recognise the use of weighted averages in order to attempt to smooth out business cycle fluctuations and other atypical volatility in company or industry data.

It is, however, important that a certain flexibility in the use of historical data be preserved. Although the OECD Guidelines may benefit from a recommendation to use, for example, at least three years of data, circumstances may dictate that four or five years of data is more appropriate. Furthermore, where a clear and distinctive trend can be identified, such trends may be taken into account in determining an appropriate point in a range of profit level indicators.

In addition to the above, as transfer pricing policies are often based on the use of historical data, the business community would welcome review by the OECD on the use of retroactive adjustments. Such adjustments can be imposed by tax authorities notwithstanding the fact that the taxpayer acted in good faith, is convinced that the arm's length principle was adhered to, and has the transfer pricing documentation to support its internal pricing policy. Furthermore, a taxpayer's transfer pricing policy may be determined by, for example, targeting a certain return on sales targets. However, if these targets are not met, for example due to discrepancies between budgeted sales volumes and actual sales volumes, a "true up" payment may be needed at the end of the financial year to ensure that the predetermined transfer pricing policy is adhered to (please refer below for an example of such true up payments). We therefore submit that the OECD Guidelines should consider issues that are encountered by the business community when confronted with retroactive adjustments. Such issues include indirect taxes, customs charges, timing of retrospective adjustments, the impact on tax payments and penalties, various non-tax regulatory practices in which price is a component (eg. health regulations in pharmaceutical industry), and recourse to mutual agreement procedures to mitigate double taxation.

EXAMPLES:

- A practical example of historical data not capturing recent trends is the downturn experienced by several industries after 11 September 2001. Historical data, e.g. 1999 to 2001 data, used to benchmark a taxpayer's results for 2002 or 2003 may support higher returns than are actually achievable at arm's length in the more recent years. In this case, recognition of the trend may lead the transfer pricing analyst to target a point in the range that is below the median obtained from the historical data.

- A tax authority imposes a retroactive downward adjustment to a taxpayer's transfer prices. However, the taxpayer paid customs duty on the unadjusted (higher) price of the goods. This may not only lead to double taxation, but raises a clear customs duty issue.

- A taxpayer performs the function of routine distributor for its overseas parent. The group applies a transfer pricing policy for goods whereby it targets a certain level of operating margin(s) for its routine distribution subsidiaries. However, due to unforeseen circumstances, actual sales volumes fall short of expected sales volumes in a jurisdiction and as a result a distribution entity is unable to meet the targeted operating margin level. The overseas parent therefore considers paying a "true up" payment to this distribution subsidiary in order to adhere to the agreed transfer pricing policy. As this true up payment effectively results in decreasing the transfer price paid by the subsidiary, related indirect tax, potential double taxation and customs duty issues arise.

Issue: COMP 6 – Choice of relevant sources of information, including but not limited to commercial database

BIAC members believe that the use of some commercial databases to analyse adherence to the arm's-length standard is practical. The advantages of using commercial databases include (i) time efficient screening procedures; (ii) uniform reporting of financial data (a benefit that may be optimised when International Accounting Standards are introduced in most OECD countries); and (iii) reliance on data compiled by unrelated parties. A main disadvantage of commercial databases is the delay in obtaining the data as companies generally have several months before their results need to be lodged with the relevant supervisory authorities. However, this disadvantage has been discussed in detail under "COMP 5" above. Database information must, of course, be used properly.

For jurisdictions/situations where publicly available data is limited, we advocate a re-focusing of the comparability standards in order to obtain a larger set of comparable companies. This approach will enable the transfer pricing analyst to draw statistical inferences from the results obtained. Please also refer to "COMP 8" below for a more detailed discussion on reasonable comparable set size.

With respect to the above, we reiterate our comment made in "COMP 3". Although additional information may be available from a wide range of alternative sources, tax authorities should be conscious of the additional compliance burden the analysis of all available sources may impose on the taxpayer. A cost benefit analysis should be advocated by the OECD so that smaller taxpayers who do not have the resources available to explore every possible source of information may rely on data available in databases compiled by third party service providers (e.g. Bureau van Dijk).

EXAMPLES:

- Tax authorities in Mexico have accepted financial information obtained from North American databases due to a lack of publicly available information on independent Mexican based companies.

- The Australian Taxation Authority ("ATO") has accepted the use of US-based comparable companies in cases where financial data on Australian companies was inappropriate and/or unreliable.

- The New Zealand transfer pricing guidelines accept foreign databases, provided appropriate adjustments are made to account for potential substantial differences in market and country.

Issue: COMP 7 – Definition of comparability adjustments where they are appropriate

There is a clear value in developing further guidance on comparability adjustments, as it would provide clarification to taxpayers and tax authorities alike.

In this respect, we note that working capital adjustments, i.e. bringing the inventory, accounts receivable and account payable levels of the comparable companies in line with those of the tested party, are commonly applied in certain jurisdictions. It is submitted that the OECD Guidelines should provide further explanation as to their applicability in certain situations as well as to the interest rate that should be applied when performing this type of adjustment.

It is further noted that performing a working capital adjustment can provide, at a minimum, an indication as to the level of working capital comparability of the selected companies. If by performing a working

capital adjustment the results of a search are substantially altered, this may give an indication that the selected companies were not sufficiently comparable to the tested party.

In addition to the above, we submit that the OECD Guidelines should recognise that, given certain facts and circumstances, adjustments to the tested party's data is warranted and desirable. It is submitted that adjustments to the tested party's financial data should be permitted to exclude the effects of non-transfer pricing related events (please refer below for a clarifying example).

Given the above comments, it is submitted that further guidance on comparability adjustments is required from the OECD. It may be helpful to incorporate examples into the OECD Guidelines with respect to adjustments in order to guide the taxpayers and tax administrations. Such examples should not be restrictive as limitations with respect to available information may be encountered. Furthermore, flexibility in applying adjustments should be preserved as the appropriateness of certain adjustments will depend on the specific facts and circumstances of the related party transaction under review.

EXAMPLES:

- We are aware of circumstances where a taxpayer performed a regression analysis to determine appropriate adjustments to the comparable companies. Although this approach was accepted by one tax authority, it was rejected by another tax authority, hence creating a potential double taxation issue for the taxpayer.

- The US Internal Revenue Service ("IRS") routinely requires taxpayers to perform working capital adjustments to increase comparability.

- Adjustments to the tested party's data may be desirable where non-transfer pricing issues have materially impacted the results of the tested party. For example, a related party may have incurred substantial expenses in installing a computer system from a local third party. This cost may appear in the P&L as an operating expense, but is in substance a non-recurring, non-transfer pricing related and extraordinary cost. However, depending on the relative size of the expense, the installation may materially impact the company's results and this impact should be recognized in a transfer pricing analysis.

Issue: COMP 8 – Interpretation and use of data collected

BIAC members submit that the application of an interquartile range should be endorsed by the OECD in circumstances where it is appropriate.

On a related point, it is also submitted that the OECD Guidelines should provide further guidance as to what constitutes a reasonable number of comparable companies. We strongly support the use of larger comparable sets as more reliable statistical inferences can be drawn from such sets when compared to smaller sets. The larger the number of observations, the more the results obtained will converge to a standard normal distribution thereby allowing the transfer pricing analyst to arrive at statistical results that are more robust[1].

Where only a limited number of comparable companies could be identified in one jurisdiction, it is submitted that the use of public data from a different, but economically similar, jurisdiction should be

[1] Also known as the "law of large numbers", or the "central limit theorem", which dictates that the distribution of an average will tend to be Normal as the sample size increases, regardless of the distribution from which the average is taken ***except*** when the moments of the parent distribution do not exist.

allowed. If necessary and where possible, adjustments to the comparable companies could be made to take into account certain market differences, such as adjustments for differences in relevant economic differences between countries, e.g. interest rates.

It is further submitted that loss-making companies should not automatically be excluded from consideration as potentially comparable companies, particularly where a company does not report losses for all of the years under consideration. Automatically excluding loss making companies from a set of potentially comparable companies ignores the business reality that independent companies do on occasion incur losses. However, where a company is in bankruptcy or receivership, or where its auditors have expressed reservations about its ability to continue as a going concern, we submit that it may be appropriate to exclude such companies from a set of potentially comparable companies. It is therefore important to understand the reasons for the observed losses before a decision is made whether to reject or accept a loss-making company for benchmarking purposes.

Issue: COMP 9 – Specific comparability issues when applying transactional profit methods

A difference in accounting treatment, resulting in differences in the classification of certain expenses, may impede the application of traditional transaction methods. In addition, the level of financial data availability in commercial databases heavily depends on the disclosure requirements in the jurisdiction where the potential comparable company is located. For example, certain countries do not require corporate entities to disclose gross margin information and as such render the application of a resale price method difficult if not impossible. In such cases, transactional profit methods are likely to produce results that are more robust and reliable than the results obtained from a traditional transaction method. In addition, please refer to the comments made in "COMP 1" to "COMP 8" above, as they are relevant to the application of TNMM in this context as well.

However, with respect to profit split methods, we caution the OECD against giving prescriptive guidance. By virtue of its nature, the application of a profit split method will vary from situation to situation as the taxpayers and tax authorities need to take into account the relevant facts and circumstances.