

Paris: 11 April 2014

OECD DISCUSSION DRAFT ON TRANSFER PRICING COMPARABILITY AND DEVELOPING COUNTRIES

Submitted by email: TransferPricing@oecd.org

Dear Joe,

Please find below BIAC's comments on the OECD Discussion Draft on Transfer Pricing Comparability and Developing Countries, issued on 11 March 2014 ("The Discussion Draft").

BIAC supports the Discussion Draft's objective of strengthening the application of the arm's length principle ("ALP") by providing guidance to allow tax authorities and taxpayers to improve access to the information and tools required to perform comparability analyses in a responsible, efficient way. Our comments below focus on ways to help achieve these shared goals.

General Comments

1. BIAC considers it very important that any guidance for Developing Countries should represent a transitional simplification, facilitating the evolution towards a global standard, rather than creating a permanent different standard for Developing Countries. This may be the intention of the project; however, BIAC would recommend making it an explicit objective. This would help to ensure that any interim practical solutions are also compatible with a longer-term program, under which the largest possible number of countries will share the same principles and methodologies.
2. It is also important to recognise that, in some cases, even moving to a common interim standard will require significant investment from some developing countries as they focus on increasing their capacity to deal with Transfer Pricing ("TP") and other international tax issues. Such countries may require specific practical assistance to develop the critical infrastructure before they can adequately focus on TP issues. During that interim period, practical guidance should be considered by the OECD to assist in creating certainty and stability for those countries. The development of TP safe harbours would be one potential option, to act as an interim measure until local and regional comparability information has been adequately developed and can be effectively used.
3. BIAC observes that the Discussion Draft gives the impression of focusing only on two key stakeholders: local tax administrations of Developing Countries and foreign multinationals. BIAC believes it is also very important to focus on "local" multinationals (i.e. companies based

in Developing Countries that are becoming “multinationals” by expanding activities into neighbouring countries).

4. BIAC suggests the addition of an explicit reference to the underlying objective of promoting the growth of Developing Countries’ economies. In BIAC’s view, this should include the promotion of solutions that are compatible with the more practical and less complex current OECD TP methods¹ (among the existing OECD recognized methods) rather than promoting new or complicated methods. New methods would create inconsistencies with the current Transfer Pricing Guidelines (“TPG”) and would likely prove difficult to implement. This would potentially create significant uncertainties for local and regional small and medium multinationals (“SME”).
5. In light of the above comments, BIAC is concerned that some of the proposed solutions could potentially weaken the ALP or even depart from it. While BIAC does support the principle of simplification and expanding availability of comparable data, it is essential that the ALP remains the foundation for all comparability analysis.
6. Initiatives to improve the situation in Developing Countries with regards to the availability and use of comparability data, should be strongly focused on implementing coordinated capacity building actions. The intention should be to help tax authorities to improve their understanding of the ALP and TP documentation as well as how they should implement and administer them in practice, especially in the course of tax audits.
7. Finally, BIAC considers that safe-harbors, Advance Pricing Agreements (“APA”) and Mutual Agreement Procedures (“MAP”) are undoubtedly mechanisms to be supported and developed over time by Governments and tax administrations in order to reduce uncertainty in the application of the ALP and the risk of double taxation, especially in developing countries.

Background

8. When analysing pricing comparability issues in Developing Countries, it is necessary to first start with the basic principle, being the ALP as defined in Article 9 of the OECD Model Tax Convention.
9. It should not be forgotten that the use of comparable data is intended as a means to establish an approximation of what independent parties would have agreed to in the same or similar circumstances, which is the essence of the ALP. Generally, independent parties would have taken into consideration internal elements: manufacturing and marketing costs, cost of capital, marketing policy, price policy, etc.
10. Generally speaking, financial information provided by existing databases does not meet the precise requirements needed to apply the ALP. With the exception of certain specific data bases related to royalty rates, commodities prices, etc., financial databases provide information on entity results and not the prices of individual transactions. They also operate on an ex-post basis while transfer prices are generally fixed on an ex-ante basis. They provide information by company, not activity, etc. An extension of the use of financial databases in

¹ Comparable uncontrolled price method, Resale price method, Cost plus method and Transactional Net Margin method.

Developing Countries should therefore address an acceptable level of quality, but also avoid setting more ambitious standards than those practically in use in Developed Countries.

Specific Comments

Expanding access to data sources for comparables

11. BIAC strongly encourages initiatives that would engage suppliers of databases in improving Developing Country coverage and access, as well as initiatives promoting the improvement of the quality and suitability of data provided for TP purposes. This would generally represent significant progress towards more certainty and fewer TP disputes.
12. Paragraph 16 of the Discussion Draft considers the pros and cons of requiring companies to file statutory accounts and making that information available to the public as a way of expanding the availability of comparables data in Developing Countries and elsewhere. BIAC observes that this is a complex issue and that finding a common denominator that could be adopted by a large number of countries will be more difficult if the disclosure requirements will imply the publication of a broad set of information. Even in some Developed Countries, there is experience of resistance and non-compliance to statutory disclosure requirements, mainly linked to confidentiality issues. Such confidentiality issues sometimes have a cultural background but always refer to protection of information that is perceived as sensitive (e.g. in relation to employment information, trade secrets, and other information that may be reflected on the statutory accounts). BIAC therefore recommends that solutions proposed in this area target very limited and summarized disclosures, consistent with the limited set of information that is currently available in most databases for Developed Countries. BIAC also observes that such requirements need to be based on the existence of financial reporting standards in Developing Countries: the OECD could propose initiatives to support countries for the development of clear and reliable financial reporting principles, ideally adopting common financial reporting standards.
13. Paragraph 17 of the Discussion Draft raises the possibility of tax administrations making use of data they collect to obtain comparables or to populate an internal (tax administration access only) database. This raises the concern over the use of secret comparables. BIAC and other business organizations have previously objected to the use of secret comparables as a matter of fundamental fairness. BIAC would also like to stress the fact that the use of secret comparables would particularly penalize small local companies who will have great difficulty in developing defensive arguments to the use of such data. The use of secret comparables could also damage a Developing Country's capability to attract foreign business due to the uncertainty that this would create. Nevertheless, if a country decided to use secret information for risk assessment purposes the process should be made as transparent as possible. For example, this could include creating ranges of industry average Profit Level Indicators in a useful, searchable, anonymous and publishable format. BIAC also discourages the development of any wording that could promote or justify the use of secret comparables where there is a lack of good comparables.
14. In addition to the discussion at paragraph 14 about solutions to favour Developing Countries' access to commercial databases, BIAC recommends that the OECD should also consider the issue of how regional SMEs could access such databases in a cost effective way.

More effective use of data sources for comparables

15. BIAC agrees on the importance and difficulty of developing the skills required to ensure the proper use of commercial databases. BIAC encourages education initiatives (through the OECD's existing "Tax Inspectors Without Borders" or "Capacity Building" programs). We also note that experience could also be gathered from Developed Country tax authorities that have either developed or expanded their TP capabilities recently and have managed to enhance and improve their use of comparables data within the existing TP framework. Also, experience could be shared in the use and gathering of data in addition to the use of Tax Treaties or Tax Information Exchange Agreements ("TIEA") to enable information sharing between countries.
16. BIAC observes that tax authorities and taxpayers can learn from each other by improving dialogue. Tax authorities should be encouraged to engage with taxpayers in order to understand the justifications for using particular comparables data before issuing assessments. This is particularly relevant in situations where a lack of comparables data or a lack of understanding of that data could result in the wrong conclusion being reached. A closer dialogue will allow tax authorities to develop a better understanding of the relevant industries and sectors they are reviewing, and how companies operate within those industries and sectors on a global basis,
17. BIAC is in favour of broadening the search for comparables to uncontrolled transactions in other geographic markets or other industry sectors in appropriate circumstances (for example when insufficient 'in country' data is not readily available). BIAC also observes that with the progressive globalization of the economy, the use of regional comparables data should more frequently be recognized as an appropriate solution.
18. BIAC believes that a fact-based study (for example analysing groups of Countries to identify similarities between regions) could lead to the conclusion that certain regions do have sufficiently homogeneous results in a sufficiently large number of sectors, allowing the expansion of the use of regional comparables to all sectors.
19. One precursor example in this area is the 2009 European Union Joint Transfer Pricing Forum Business Members contribution to illustrate available generic evidence relating to intra group services profit margins². We encourage the OECD to gather information from European tax authorities about their practical experience of simplifications brought by that study in dealing with comparability issues.
20. BIAC supports the initiative of reviewing country experiences in relation to country adjustments and the study of and possible development of additional guidance. Building on the existing practical guidance on how to perform working capital adjustments, the OECD should also issue practical guidance for how to adjust for geographical differences, such as cost of capital and making country risk adjustments. The OECD could play a very positive and useful "standard setting" role here, perhaps considering the applicability of risk assessment frameworks used in the ordinary course of business as a starting point. However, guidance on

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http://ec.europa.eu/taxation_customs/resources/documents/taxation/company_tax/transfer_pricing/forum/jtpf/2009/jtpf_018_back_2009_en.pdf

adjustments should remain consistent with the principles set by section A.6. of Chapter III of the OECD TPG.

21. BIAC also agrees that countries – including Developing Countries – should have access to information necessary to determine appropriate transfer prices. Paragraph 22 of the Discussion Draft raises the question of testing the return earned by the foreign counterparty as an alternative to a domestic evaluation. We believe that paragraph 3.18 of the current TPG reaches the correct conclusion in this regard: that is, it is not appropriate to treat the foreign counterparty as the tested party if it is the more complex party to the related-party transactions. The discussion in paragraph 22 has the effect of inviting tax authorities to treat as routine other complex functions such as IP development, high-value services and at-risk manufacturing.
22. In addition, it should be noted that if the approach of some countries such as Canada, referred to in the paragraph, is followed, confidentiality of the required data is very important, so that where such foreign information is used, countries must commit to protecting the information from inappropriate disclosure. Tax treaties provide safeguards that protect these interests, and while many Developing Countries do not have comprehensive treaty networks, the Mutual Legal Assistance Treaty or the Convention on Mutual Administrative Assistance in Tax Matters is available to them. BIAC and other business groups have made this point in previous submissions; the expectation of access to information requires a corresponding obligation to protect that information.
23. Paragraph 23 also states that sector averages and consolidated global returns may need to be considered. We are concerned that the reference to consolidated global returns implies a method of allocating such returns in an arbitrary way to all companies participating in the generation of that return. BIAC strongly rejects the proposed use of such methods that deviates from the use of the ALP and could represent a shift to formulary approach. If the use of sector averages and consolidated global returns are intended as a high-level check on the reasonableness of a comparables analysis, then that should be made clear. The guidance should also make it clear that an allocation or apportionment of consolidated global returns is not appropriate.
24. Finding comparables for certain functions can also be difficult for countries that do have access to financial databases. It is challenging, for instance, to identify distribution comparables in China and India because of the nature of the market. The problem of having too few comparables and limited databases (a problem in developed and developing countries) could be significantly ameliorated if the OECD were to develop practical guidance on how to adjust the financial results of companies in other countries to apply to the country of the tested party. On the other hand, increasing the number of comparables or accessing more data does not necessarily improve the quality.
25. Similarly, for industries where finding appropriate comparables is generally a challenge, it would be very helpful for the OECD to issue guidance that makes it clear that a company is not disqualified from serving as a comparable merely because it has intercompany transactions (so long as those transactions do not exceed a reasonable threshold). For example, in Korea and India, tax authorities allow companies to serve as comparables even though they have related party transactions provided that those transactions are not

significant. The local databases for these countries provide information on the quantum of related party transactions that makes this analysis possible.

Approaches to reducing reliance on direct comparables

26. The first sentence of paragraph 24 mentions internal comparables without any additional information or explanation on their use. BIAC considers that the potential usefulness of internal comparables should be clearly stated and that also internal “other methods”³ should be considered before considering more indirect and complicated methods.
27. Although paragraph 24 specifically rejects the use of formulary apportionment, BIAC is very concerned that some of the suggestions in this section of the Discussion Draft seem to nonetheless recommend a form of formulary apportionment in some cases. It is therefore recommended that any alternative approaches should all be solely based on the ALP and only include methods that result in a reasonable approximation of what unrelated parties would have agreed upon in similar circumstances.
28. Paragraph 25 of the Discussion Draft mentions economic analysis and global value chain analysis but doesn’t explain them, probably because these concepts are still under discussion for their possible more general application in TP matters. Even without entering here into a detailed discussion of these concepts, BIAC expresses strong reservations on both and finds it inappropriate to reference them without clarity on their use, with the risk of unpredictable interpretation of these concepts by Developing Countries. In addition, as illustrated in other sections of this document, BIAC considers that solutions for Developing Countries should, as far as possible, be straight-forward to understand and practical to implement.
29. Paragraph 25 of the Discussion Draft also recommends the use of the profit split method as an alternative due to a lack of comparables. The OECD suggests that the profit split method “can offer a solution for highly integrated operations for which a one-sided method would not be appropriate⁴,” “where both parties to a transaction make unique and valuable contributions⁴,” or “in the presence of unique and valuable contributions⁴.” We note in this regard that the application of the profit split method (using a residual analysis) still requires comparables data in order to allocate the routine return as the first step. Similarly, the application of the profit split method using a contribution analysis is often dependent on comparable data. See the following relevant extract from the OECD TPG:

“2.110 Where comparables data are available, they can be relevant in the profit split analysis to support the division of profits that would have been achieved between independent parties in comparable circumstances. Comparables data can also be relevant in the profit split analysis to assess the value of the contributions that each associated enterprise makes to the transactions...”

³ For example, a simple pricing algorithm used with third parties for certain products and with related parties for different products could be considered arm’s length because applied consistently and because functions/assets/risks are similar. These type of approaches would be particular helpful with small regional multinationals that may often adopt empirical solutions in the absence of adequate skills and resources.

⁴ Para 2.109 TPG

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30. For tax administrations with limited resources, the increasing application of the profit split method may prove to be more challenging than making reasonable adjustments to regional or other comparable data.
 31. BIAC strongly supports the OECD's effort to encourage the use of safe harbours, particularly bilateral safe harbours. Appropriate bilateral safe harbours provide certainty to MNEs as well as tax administrations without the need for MAP or APAs. However, it should be recognized that a safe harbour may not be consistent with the facts and circumstances of all cross-border transactions within groups, and should therefore be elective and based on the ALP. Where safe harbours are not based on the ALP, the experience of business is that they create a material risk of economic double taxation.
 32. For the reasons the OECD so clearly sets out in paragraph 27 of the Discussion Draft, BIAC does not support the use of the so-called sixth method, which is unilateral and arbitrary, and in many cases will not be reconcilable with the ALP, leading to a material risk of economic double taxation. The Sixth Method does not consider the value created by any strategic functions, marketing, product premiums, logistics, financial support to customers and suppliers, shipping, stockholding and other strategic value adding responsibilities that are being performed by the party to the overseas transaction.

Advance pricing agreements and MAP

33. BIAC strongly supports the availability of APAs and MAP to resolve TP disputes. In particular, bilateral APAs offer the possibility of resolving issues before they become contentious and allow taxpayers to have certainty with respect to their pricing, accounts, and tax returns. Appropriate MAP procedures, including mandatory binding arbitration, are critical to a fully functioning TP system. Disputes will inevitably arise between MNEs and tax administrations and unless there is an effective way to resolve them, double taxation will result, with the attendant harm on foreign direct investment and bilateral trade. Consequently, BIAC strongly supports the efforts of the OECD to assist Developing Countries in establishing fully functioning APA and MAP programs, and allowing competent authority disputes to be resolved through mandatory, binding arbitration. With respect to encouraging APA and MAP approaches, and as an interim measure, BIAC suggests that in cases where a treaty does not currently exist, practical protocols could be developed that countries can use to facilitate bilateral discussions.
34. We encourage the OECD to actively consider simplified procedures for small taxpayers and low value transactions. Such simplified procedures might represent a useful starting point for Developing Countries that are beginning their TP journey. The OECD's Manual on Effective Mutual Agreement Procedures ("MEMAP") may also provide useful guidance to Developing Countries on setting up and running an effective MAP program.