

April 29, 2008

Mr Jeffrey Owens
OECD Centre for Tax Policy and Administration
OECD
2, rue André Pascal
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France

Dear Mr. Owens, members of the Baker & McKenzie Global Transfer Pricing Practice (“Baker & McKenzie”) are pleased to provide the following comments in response to the OECD Centre for Tax Policy and Administration’s public invitation to comment on the series of Issues Notes on Transactional Profit Methods (“Transactional Profit Methods: Discussion Draft for Public Comment”, hereinafter referred to as “the Discussion Draft”), released on 25 January 2008.

Baker & McKenzie believes that the widespread choice and use of Transactional Profit Methods by taxpayers underlines the significance of the outcome of the work undertaken by the OECD in revisiting the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (“the Guidelines”) in relation to the choice and application of the transfer pricing methods.

Baker & McKenzie therefore welcomes the OECD’s effort in reconsidering the current position expressed in the Guidelines in relation to the status of Transactional Profit Methods vis-à-vis the Traditional Transaction Methods.

In the Annex to this letter, we have summarized what, in our view, are the main points submitted by the Discussion Draft. Against most of these points we provide our comments.

Sincerely,

General Remarks

With the passing of time, tax authorities have become significantly more experienced with the application of the Transactional Profit Methods (hereinafter referred to as “TPMs”). Given the widespread usage of TPMs among taxpayers, it is in practice difficult to see them as still being a “measure of last resort”. Rather, as reflected in the Discussion Draft, the right transfer pricing method should be the most appropriate method in the circumstances, not a consequence of rigidly applying a hierarchy of stipulated methodologies.

1) Status of Transactional Profit Methods as Last Resort Methods

The Discussion Draft proposes softening the language used in the in the Guidelines regarding the use of TPMs as a method of last resort. The Discussion Draft proposes that the aim of the selection of transfer pricing methods should concentrate on identifying the most appropriate method in the circumstances under consideration, and that there should be a move away from the consideration of Traditional Transaction Methods being superior to TPMs. To achieve this aim, the Discussion Draft recommends taking into account the relative strengths and weaknesses of each method; the comparability of the transaction under review; the availability of sufficient information; and the reliability of any adjustments proposed.

Baker & McKenzie generally agrees with the above proposal. Baker & McKenzie believes that additional clarifications are required as to more precisely illustrating the term “most appropriate method”, however. Further comments are provided below.

At further length, the Discussion Draft discusses the following issues:

Comparability

In the past, the TPM methods have often been used with little consideration given to the facts and circumstances surrounding the transaction. In our experience, this has resulted in tax authorities questioning the credibility of the analysis.

The Discussion Draft submits that the choice of an appropriate method should be made once a complete understanding of the transaction has been achieved - i.e. emphasising the importance of the functional analysis element of documentation. Also, the Discussion Draft indicates that internal comparables should be favoured since they represent the best reference for the arm’s length nature of the intercompany prices. Therefore, the existence or not of internal comparables should be taken into account before the choice of the method is made.

The Discussion Draft cites situations where a net margin analysis is more robust than gross margin analysis, or where transactions involve the presence of significant non-benchmarkable intangibles and those being suitable for analysis using TPMs.

The Discussion Draft comments that a full understanding of both the controlled and uncontrolled transaction needs to be undertaken before applying the TPMs.

Baker & McKenzie is of the view that difficulties relating comparability and the application of the TPM are partially the result of insufficient information (especially comparables' information) and partially the consequence of – at times – a too superficial approach to the comparability analysis. Baker & McKenzie agrees that the comparability analysis should represent the cornerstone of the overall analysis. On the other hand, it should be acknowledged that a carefully conducted comparability analysis that addresses in detail all five comparability factors may be very complex and time consuming, as such constituting an excessive burden for most taxpayers. A comparability analysis should, therefore, be accepted as sufficiently exhaustive when the taxpayer demonstrates that he/she has made a reasonable effort in considering the most relevant comparability criteria. On this point, Baker & McKenzie is of the view that additional clarifications would be welcome in relation to a reasonable approach in assessing the materiality of transactions and consequently prioritizing in terms of amount, scope and breadth of analysis required.

Availability of data

The Discussion Draft recognises that traditional methods can be difficult to apply in countries where there is little public data available at the gross margin level and thus, the TPMs are chosen by default.

Baker & McKenzie generally agrees with this. In addition, it should also be recognized that there is generally limited availability of (financial) information organized and presented in a fashion that is immediately usable for a transfer pricing analysis. As such, often a net margin analysis presents more advantages than drawbacks in terms of comparability, due – for instance – to relative irrelevance of classification of cost items as, in fact, also mentioned in the Discussion Draft.

Adjustments

The Discussion Draft comments that the reliability of comparable adjustments which may be needed to eliminate differences between controlled transactions is an important factor in determining the appropriate method.

Baker & McKenzie is of the view that often adjustments are not seen with particular favour by some Tax Authorities. As such taxpayers may be at times discouraged from performing adjustments. In addition, the use of the interquartile range should already be regarded as an adjustment to enhance comparability.

The Discussion Draft proposes new wording for, in particular, paragraphs 1.68 and 2.49 of the Guidelines summarising the above points. However, the Discussion Draft does not propose changing the wording of paragraph 1.69.

Baker & McKenzie is of the view that, whilst the Discussion Draft maybe softening the language used in the Guidelines it is still open for interpretation as to how far down the line the OECD is going in adopting a “Best Method approach.” As a consequence, although the proposed wording of paragraph 1.68a suggests that the OECD does not expect all methods to be tested and analysed, Baker & McKenzie is of the view that in light of the proposed wording of paragraph 1.68 and 1.68a, Tax

Authorities may take a different view. Statements in the Discussion Draft such as "the selection of a transfer pricing method always aims at finding the most appropriate method for a particular case" are likely to be open to interpretation by revenue authorities. Furthermore, it should be made explicit that in case a typical search process is referred to in paragraph 1.68a, this should not constitute a binding reference either to the Tax Authorities or to taxpayers but a mere sample for illustrative purposes, as in our experience search processes and sources of information may greatly vary depending on the circumstances of the case.

2) Multiple Methods

The Discussion Draft concludes that the use of multiple methods is valid as a sanity check to identify unusual outcomes or otherwise review the use of a primary method and its application including comparability analysis in particular.

Baker & McKenzie believes that the use of several methods to test the same transaction should remain an option for the taxpayers and not a requirement under any circumstances. It should also be emphasized that, if a taxpayer has sufficiently corroborated and justified the choice of one particular method, the Tax Authorities should not challenge the taxpayer on the basis of different results obtained through the application of another method. Furthermore a question to be addressed in relation to the use of secondary or multiple methods also concerns the comparables used. In particular, the use of a secondary method may be envisioned in order to corroborate the validity of the comparables selected through the application of the primary method,

3) Available Data

The Discussion Draft recognises that access to data is critical for all transfer pricing methods, which necessitates access to qualitative information to be collected on the non-tested party (irrespective of whether the non-tested party is a foreign or domestic entity). The level of detail required is dependent on the method used, i.e. one-sided or two sided. In particular, in the two-sided situation (e.g. profit split) significant information on the non-tested party will be required.

Baker & McKenzie submits that availability of information and cost thereof is one of the most critical aspects of a transfer pricing analysis. As such, in justifying the choice of a method material relevance should be given to the (non-)availability of information and the reasonable efforts made by a taxpayer to that extent. It is Baker & McKenzie's view that the Discussion Draft increases the burden on taxpayers to prepare documentation. In particular, for situations where a one-sided method (such as a TNMM) is applied the Discussion Draft indicates an expectation that the taxpayer prepare a full analysis for each party to the transaction(s). In some circumstances, where the tested party undertakes functions which are of low-added value and low-risk exposure it could be said that the obligation of all parties to the transaction to prepare a full analysis is an onerous and unnecessary step.

4) Transactional Profit Split Method

The Transactional Profit Methods can be particularly useful in cases involving unique contributions intended as non-benchmarkable functions, assets or risks for which no sufficiently reliable comparable

data are available. In particular, the Discussion Draft proposes to broaden the scope of application of the Profit Split Method arguing that this method may be found to be the most reliable method when both parties to the transaction make unique contributions and independent parties at arm's length might wish to share the profits in proportion to their respective contributions or a two-sided method might be more appropriate than a one-sided method¹. In addition, it is suggested that a transactional profit split method might be useful as a sanity check in cases where accounting for differences in risk levels and the realisation of risks is difficult. On the other hand, the Discussion Draft clarifies that the Transactional Net Margin Method may be appropriate in cases where one of the parties makes all the unique contributions and in particular uses all the key intangibles involved in the controlled transaction, while the other party does not make any unique contribution. In such a case, the tested party shall be the less complex one.

Baker & McKenzie submits that beside the concept of unique and un-benchmarkable contributions, the Profit Split Method can also be the appropriate method when the assets, functions and risks employed in the inter-company transactions are equally owned/shared between the parties, and it is therefore impossible to identify a non-tested and a tested party. This might set aside from the concept of unique contributions.

Determining or testing a license fee

The Discussion Draft points out that the application of the Transactional Net Margin Method, whereby the licensee is the tested party, is sometimes used alone or in conjunction with any of the other approaches in order to ensure that the remuneration of the licensee after deduction of the license fee remains within an arm's length range. The measure of the net margin derived by independent parties comparable to the licensee might provide a measure of the level of net margin the licensee would seek to achieve at arm's length, and accordingly an indirect measure of the maximum level to which the license fee may be set from the perspective of the licensee. The Discussion Draft acknowledges that, a number of countries recognize that the use of the Transactional Net Margin Method to test the outcome of a transaction involving a licensing arrangement, rather than to set the licence fee, might lead to changing the license fee every year, possibly retroactively, based on the performance of the licensee and, therefore, it would not be regarded as a usual business practice between independent parties at arm's length.

Baker & McKenzie submits that the approach described in the Discussion Draft should be regarded as acceptable in those circumstances where the licensee does not materially contribute to the value of the intangible property and incurs limited (routine) entrepreneurial risks. Associated enterprises merely sub-licensing the property to third parties could represent an appropriate example. At the same time, Baker & McKenzie acknowledges that setting a license fee ex-post and in correspondence with a benchmarked residual profit is not a common commercial practice and could have the effect of shifting the entrepreneurial risk from the tested party to the Intellectual Property owner.

¹ This could already be read between the lines at Paragraph 3.6 of the Guidelines (As a consequence, the profit split method offers flexibility by taking into account specific, possibly unique, facts and circumstances of the associated enterprises that are not present in independent enterprises, while still constituting an arm's length approach to the extent that it reflects what independent enterprises reasonably would have done if faced with the same circumstances).

5) Transactional Net Margin Method and standard of comparability

The OECD is of the view that a sufficiently reliable comparability analysis must be performed in all cases in order to select and apply a transfer pricing method and that the process for selecting and applying the Transactional Net Margin Method should not be less rigorous than for other methods. That being said, the discussion draft on comparability issues recognises that in practice the level of information available on the factors affecting external comparable transactions is often limited. Finding a reasonable solution to all transfer pricing cases requires flexibility and the exercise of good judgement.

Baker & McKenzie generally agrees with the above. It is current common practice that part of comparability analysis for the application of the Transactional Net Margin Method is based on the analysis of information often sourced through the Internet as this is the main source of publicly available information. Alternative sources of information may be either accessible with difficulties or (sometimes) at a high cost. As previously submitted, a comparability analysis should therefore be accepted as sufficiently exhaustive when the taxpayer demonstrates that he/she has made a reasonable effort in considering the most relevant comparability criteria.

Aggregation of Transactions

In addition, the Discussion Draft recognizes that strong concerns have been expressed by countries in relation to aggregation / segmentation of taxpayer and comparable transactions and use of company-wide information. While these issues are not specific to the Transactional Net Margin Method, they are in practice more acute due to the heavy reliance on external comparables when applying the Transactional Net Margin Method. In this respect, the Discussion Draft reintroduces the concept of “Portfolio Approach” as a business strategy consisting for a taxpayer in bundling certain transactions for the purpose of determining or testing its transfer prices. Portfolio approaches are not specific to the Transactional Net Margin Method and they are simply an example of a business strategy that may need to be taken into account in the comparability analysis and when examining the reliability of comparables. The enterprise may accept that there will be some products that do well and others that do not, but the overall outcome remains acceptable. In some cases, the poorly performing products may have overall benefits in supporting or complementing other, more profitable products or a product range. This can be acceptable if the intention of the taxpayer to adopt such a portfolio approach is documented and makes economic sense.

Baker & McKenzie notes that the portfolio approach is in fact a common business strategy and in some circumstances is industry practice insofar as there are price restrictions or price controls or other restrictive regulatory requirements that would not allow for all products to be profitable but only for a combination or portfolio of products/services.

6) Transactional Net Margin Method and selection of the Profit Level Indicator

The Discussion Draft confirms that as matter of principle, only those items that directly or indirectly relate to the controlled transaction at hand and are of an operating nature should influence the determination of the net profit margin for the application of the Transactional Net Margin Method:

- *Costs and revenues*: an analysis under the transactional net margin method should consider only the profits of the associated enterprise that are attributable to particular controlled transactions. Therefore, it would be inappropriate to apply the transactional net margin method on a company-wide basis if the company engages in a variety of different controlled transactions that cannot be appropriately compared on an aggregate basis with those of an independent enterprise;
- *Non-operating items*: income taxes should be excluded from the determination of the net profit margin indicator because they are not of an operating nature. Exceptional and extraordinary items of a non-recurring nature should generally be excluded. This however is not always the case as there may be situations where it would be appropriate to include them.
- *Financial terms*: interest income and expenses other than those on trade receivables and payables should generally be excluded. In some cases it might be appropriate to include interest in respect of short-term working capital within the net profit margin calculation, e.g. if credit terms can affect sales prices or operating margins. An example would be where a large retail business benefits from long credit terms with its suppliers and from short credit terms with its customers, thus making it possible to derive excess cash that in turn may make it possible to have lower sales prices to customers than if such advantageous credit terms were not available. Whether foreign exchange gains and losses should be included or excluded depends on whether they are of a trading nature (e.g. exchange gain or loss on a trade receivable or payable that was not hedged) and on whether or not the tested party is responsible for them.
- *Depreciation and amortization*: whether or not to include depreciation and amortisation costs depends on the circumstances of the case. Depreciation and amortisation charges are very susceptible to differences in accounting treatment and in particular in the deemed accounting life of the asset. This may materially distort the comparison between the tested party's results and those of third party comparables in asset-intensive industries and depending on the circumstances of the case a more reliable comparison might be achieved using a net profit margin ratio that does not include depreciation and amortisation.
- *Start up and termination costs*: whether or not include these cost items depends on the facts and circumstances of the case and on whether in comparable circumstances, independent parties at arm's length would have agreed either for the party performing the functions to bear the start-up costs and possible termination costs, or for part or all of these costs to be recharged with or without mark-up to the customer / principal.
- *Pension Costs and Stock Options*: pension costs and stock options can raise difficult issues in particular with respect to comparability where the accounting treatment of those items by third party comparables is unclear or does not allow reliable measurement or adjustment. Where employee stock options are elements of remuneration, there is no economic reason for treating them differently from other elements of remuneration.

Baker & McKenzie generally agrees with the above.

Actual, Standard or budgeted costs

Another issue mentioned by the Discussion Draft relates to the question of whether actual costs, standard costs determined by the management of the company based on standard capacity utilisation, or

budgeted costs based on the foreseeable activity, should be used in the application of the transfer pricing method. Using actual costs may raise an issue because the tested party may have no incentive to carefully monitor the costs. In third party arrangements it is not rare that a cost savings objective is factored into the remuneration method. It can also happen in unrelated party manufacturing arrangements that prices are set on the basis of standard costs, and that any decrease or increase in actual costs compared to standard costs is attributed to the manufacturer.

Baker & McKenzie generally agrees with the above. Baker & McKenzie submits that more guidance is required as to the acceptability and correct implementation of budget-to-actual adjustments (and more in general the so called “year-end” adjustments) in the context of the application of the Transactional Net Margin Method. Baker & McKenzie is of the view that the often diverging positions taken by Tax Authorities on the adjustments currently lead to much unsatisfactory results for the taxpayers.

The Berry ratio

The Discussion Draft submits that the arm’s length remuneration of selling activities (whether buy-and-sell activities, commissionaires or sales agents) should generally be based on a sales-related indicator, unless in comparable circumstances independent parties at arm’s length would agree otherwise. A combination of a cost-based indicator (e.g. Berry ratio) and of a sales-based indicator might also be acceptable in appropriate circumstances, for instance where the sales operation incurs significant promotional expenditure as a service performed for the principal in addition to its selling activities. On the other hand, Berry ratios can be useful to test the remuneration of intermediaries or service providers. In particular, subject to the comments below, Berry ratios can prove useful when applied to intermediary activities where a taxpayer purchases goods from a related party and on-sells them to other related parties.

In summary, the OECD clarifies that, in order for a Berry ratio to be appropriate to test the remuneration of an intermediary or service provider, it is necessary that:

- The intermediary or service provider performs functions (taking account of assets used and risks assumed), the value of which is proportional to the extent of its activities performed as reflected in its operating expenses;
- It performs functions (taking account of assets used and risks assumed) the value of which is not materially affected by the value of the products distributed and;
- It does not perform any other significant function (e.g. manufacturing function) that should be remunerated using another method or financial indicator.

Baker & McKenzie generally agrees with the above. Baker & McKenzie submits that attention should also be given to the appropriate approach to the analysis of and to remunerate intermediary activities in relation to, e.g. the purchasing/procurement function, which increasingly represent a key value-creating function/process for MNEs, or in relation to pure intermediary trading functions, where the intermediary entity is engaged in both in-bound and out-bound intercompany transactions.

7) Application of a transactional profit split method determining the combined profit to be split

The Discussion Draft emphasizes the opportunity to use a single accounting system/accounting standard for all parties taking part to the analyzed intercompany transactions, in case of application of the Profit Split Method. How profits should be measured at the operating level is explained through different examples. The choice of the measure of profits should depend on the facts and circumstance of the controlled transaction under review. The Discussion Draft also expresses reluctance in using gross profits since the definition of gross profits can differ from country to country. The measure applied in the examples could differ with respect to the inclusion of costs of different nature and the application of mark ups on single costs. The criteria for measuring the profits should be consequent to the functional and risk analysis. Furthermore, it should be verified that costs are in fact borne by the party responsible for the underlying activities. Outside the financial industry non-trading interest income and expenses and non trading foreign exchange gains and losses have generally to be excluded. Non recurring exceptional items should be excluded

Baker & McKenzie is of the view that in practice there are situations where the Profit Split Method is the only appropriate method. Furthermore it is our experience that the Profit Split Method has found higher recognition also due to a less-than-occasional application in APA negotiations (especially bi- or multi-lateral) Furthermore, it is our experience that the profit split method is often used as a secondary method for sanity check purposes. Baker & McKenzie therefore agrees with the suggested position of waiving the last resort status for both the contribution and residual profit split method.

The Discussion Draft somehow limits the applicability of the Profit Split Method to situations where unique contributions are involved. In addition to those situations, Baker & McKenzie is of the view that the Profit Split Method should also be applicable where the parties involved equally contribute in terms of functions, assets and risks involved or in transactions where unrelated parties would have been willing to enter entered into a joint venture or partnership arrangement, with the profits/revenues/cost be split between them.

Baker & McKenzie notes that the Discussion Draft does not address the point on how to identify the amount of profits to be allocated to the tested transaction in the context of applying the Profit Split Method on a transactional basis. Reference is made to circumstances where the entities involved are also engaged in other functions which are not or may not be covered by the application of the Profit Split Method on a transactional basis.

8) Application of a Transactional Profit Split Method: Reliability of a residual analysis (“RA”) and a contribution analysis (“CA”)

The Discussion Draft tends to follow the common opinion that there should not be a hard and fast hierarchy for the profit split methods. In addition, the application of a Transactional Profit Split Method through a RA may be regarded in fact as a CA conducted on the residual profit.

It is submitted by the Discussion Draft that a RA should be preferred where one or more party(ies) to the transaction is(are) characterized by functions, assets and risks for which an arm’s length remuneration can be determined either using a traditional transaction method or a TPM. These functions, assets and risks are defined by the Discussion Draft as “benchmarkable functions, assets and

risks”. The concept of the “benchmarkable functions, assets and risks” is new and should substitute the misleading expression of basic returns.

The Discussion Draft further clarifies that a CA is more reliable when direct third party data is available to determine the profit split or especially in cases of highly integrated businesses.

Baker & McKenzie generally agrees with the above. However, Baker & McKenzie’s view on the term “benchmarkable functions, assets and risks” (this potentially being a determination factor in the selection of the profit split method as an appropriate method) is that this may result in a rather subjective analysis and standpoint much open to interpretation and may have the effect of limiting the circumstances under which the Profit Split is appropriate

9) Application of a transactional profit split method: how to split the combined profit

The Discussion Draft recognizes equal validity to dividing the profits between the parties to the transaction on the basis of either external or internal data. Furthermore, it emphasises the fact that often the division will have to be exclusively based on internal data for lack of external observations. The Discussion Draft allows for a flexible approach in the selection of allocation keys. The allocation keys should fulfil the following requirement to be regarded as acceptable: (i) consistency with the comparability analysis; (ii) consistency with criteria third parties would have agreed on; (iii) they should be independent of transfer pricing policy; (iv) consistency with the profit split method chosen; (v) they should be capable of being measured in a reasonable and reliable manner.

Baker & McKenzie generally agrees with the above. A further issue related to the application of the Profit Split Method (and to the division of the combined profit) may derive from synergistic effects generated by functions otherwise to be considered having a routine nature. It could in fact be the case that the profits resulting from rendering two routine functions in coordination will be higher than the profit generated by rendering the functions separately. A correct measurement of routine and non-routine profits in the context of applying the Profit Split Method should therefore also take into account potential synergistic effects in allocating profits to the routine functions.