

December 8, 2006

Dear Jeffrey,

The Business and Industry Advisory Committee (BIAC) is pleased to provide the following comments in response to questions posed by the OECD Discussion Draft entitled "*Comparability: Public Invitation To Comment On A Series Of Draft Issues Notes*," issued on May 10, 2006 (Comparability Draft). We are pleased to provide these comments to the OECD as part of its monitoring of the effectiveness of the implementation of the 1995 Transfer Pricing Guidelines (Guidelines).

BIAC agrees that the compilation and analysis of comparable data are significant issues given their practical application for taxpayers to benchmark their various intercompany transactions. Moreover, these issues frequently arise among the multiple tax authorities involved in transfer pricing disputes.

Importantly, BIAC suggests that the Comparability Draft and changes to the comparability criteria be reflective of the fact that transfer pricing is not an exact science, and also of the need for taxpayers to apply these rules in a cost effective manner and for more straightforward resolution of disputes. We note that tax administrations will generally often face these same circumstances when they review transfer pricing practices.

We expect that other BIAC Member Organisations will separately provide you with commentary that amplifies and provides different emphasis on the matters discussed herein.

Sincerely,



Patrick J. Ellingsworth  
Chair, BIAC Committee on Taxation and Fiscal Affairs

Mr. Jeffrey Owens  
Director  
OECD Centre on Tax Policy and Administration

## **Overview**

BIAC agrees with the fundamental premise that:

*A comparison of “conditions” made or imposed between associated enterprises with those which would be made between independent enterprises is necessary to determine whether a transfer pricing adjustment may be performed.*

BIAC believes this premise underlies many issues in transfer pricing practices today. In this regard, the revision to the Comparability Guidelines should discuss factors when conditions imposed within a MNE will be respected although such conditions may not be seen among unrelated parties (e.g., the licensing of valuable intangibles and situations where functions or risks were divided between related parties). In particular, intercompany contractual arrangements to transfer risk bearing within a MNE on an ex-ante basis should be respected if economic substance otherwise exists.

BIAC recognizes that in some cases it is difficult to calculate a transfer pricing adjustment “*when special conditions* that have been made or imposed between the associated enterprises have been identified.”<sup>1</sup> A number of options may be permissible to reconcile this difficult situation including:

- Selecting a different transfer pricing method that minimizes the need to make difficult and imprecise adjustments to potentially comparable benchmarks.

For example, instead of making an adjustment to the value of a transferred intangible(s), consideration should be given to analyzing the transaction from the perspective of the entity that bears limited or no risk. I.e. a service subsidiary of a manufacturing/sales parent company because it is the least economically complex party to the transaction and it may be easier to obtain reliable market data to benchmark the transaction from this alternative perspective.

- Broadly testing the least complex functional activity with benchmarking information from different industries than those of the taxpayer if so doing increases the amount of relevant/reliable information to benchmark the controlled transaction.
- Considering review of potential comparables in different product categories rather than those of a tested party having similar economic attributions.

BIAC encourages the OECD to provide guidance that would allow taxpayers to use properly prepared documentation for more than a one year period. There are many situations where the business of a taxpayer will not change materially over time. Thus, in such situations, economic analysis that focuses on consistent returns from year-to-year may be suitable to only periodic updating.

## ***Putting a Comparability Analysis and Search for Comparables into Perspective***

### *Quality issues generally*

BIAC believes that the lack of unrelated pricing information for many unique transactions (e.g., license or sale of intangibles and provision of services) and within many geographic areas throughout the world, will inherently reduce the precision (reliability) of comparing the price of a controlled transaction with the price of in a comparable uncontrolled transaction (CUT) undertaken

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<sup>1</sup> Comparability Draft, page 4, par. 3.

between independent enterprises.<sup>2</sup> In addition, the difference in circumstances (often generated by intercompany agreements) will necessarily reduce the similarity of unrelated transactions with intercompany transactions.

The lack of direct indicia of arm's length pricing will require a combination of the use of alternative transfer pricing methods and indirect indicia to approximate what an arm's length price should be. As discussed below, the use of publicly available financial data may be appropriate in these circumstances.<sup>3</sup>

BIAC believes it is important to emphasize that the preparation of current documentation demonstrating the use of reliable information should be viewed as the taxpayer substantiating its business judgment of what it believes would be an arm's length price under comparable circumstances.

Such information should be viewed as a means of providing the tax administration(s) with the ability to test the reasonableness of the taxpayer's conclusions. The tax administration should be obligated to start its analysis from the taxpayer's documentation so long as such documents were reasonably prepared.

If such documentation is reasonably detailed to allow the tax administration(s) to replicate the analysis, the mere fact that the tax administration(s) disagrees with the taxpayer's economic analysis, the data used, or the adjustments made, should not be viewed as indicative of such a lack of quality that jeopardizes the utility of the taxpayer's analysis. Governments should recognize that transfer pricing is a type of valuation which is not scientifically exact because it is affected by numerous non-quantifiable factors.

BIAC agrees that a cost/benefit analysis should be considered in determining how much economic analysis a taxpayer should undertake to demonstrate the arm's length nature of controlled transactions (the "*prudent business management*" approach/principle).<sup>4</sup> BIAC would support clarification of this standard in Chapter 1 of the Guidelines as suggested in the Comparability Draft.<sup>5</sup>

BIAC also supports amending the Guidelines regarding the application of the prudent business management principle to material controlled transactions.<sup>6</sup> BIAC suggests such amendment/updating would include:

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<sup>2</sup> Comparability Draft, page 5, par. 7.

<sup>3</sup> Some BIAC Members note this use of such a publicly available information is very costly, and thus do not support this approach.

<sup>4</sup> Comparability Draft, page 7, par. 16.

<sup>5</sup> Comparability Draft, page 7, par. 17.

<sup>6</sup> Comparability Draft, page 8, par. 20 provides in part that:

the application of the arm's length principle might eventually resort to a prudent business management principle test, where one would try to create the theoretical arm's length environment by asking the question, whether the conditions of the controlled transaction under review are consistent with what a reasonable independent party would have done if confronted with the same opportunities or set of circumstances and quantify the adjustment by reference to profits that would have accrued at arm's length.

- Allowing an MNE to document the key factors that affect the arm's length price of a controlled transaction
- Allowing the MNE to obtain quotes or other indicia of what may be an arm's length price for a controlled transaction
- Allowing the MNE to develop a corporate structure which enhances its internal competitive environment under which it should ensure creation and maintenance of an arm's length situation for tax purposes.

BIAC is concerned, however, that the “prudent business management” principle may be wrongly understood to require taxpayers and tax administrations to develop more sophisticated standards and examples. BIAC Members’ experience is that tax administrations are less likely to accept indicia for which they lack experience or other means of verification.

The prudent business management principle is an endorsement of the judgment that the business must bring to establishing and documenting a viable set of internal prices in an imprecise and uncertain area. However, it is not an effective means of testing specific judgments. If it is so used by tax authorities, it could lead to increased tax controversy and not less, especially in those countries where the tax administrations have only theoretical and not actual business experience.

BIAC disagrees with any suggestion that the prudent business management principle would allow a tax administration to recharacterize a controlled transaction to only the types that unrelated parties may enter into.<sup>7</sup> This is especially true when the tax administration contends to “know” what a “reasonable independent party would have done”. BIAC believes that one of the unique business aspects of a MNE is its ability to manage risk more effectively on an integrated basis than for a similar value chain shared among unrelated parties.<sup>8</sup> Risk transfers are a condition that must be recognized and adjusted for even under a prudent business management principle or model. As previously discussed, a taxpayer’s self-imposed conditions regarding risk bearing, business strategies, and other economic conditions should be respected if there is sufficient economic substance.

BIAC would encourage the OECD to emphasize in the Guidelines that a tax administration audit should focus on whether the taxpayer’s determination is within a reasonable range of what the arm's length price would be for the controlled transaction. In making such a determination a tax administration should consider how the effected tax administration to the transaction may view the taxpayer’s transfer pricing model as the examination of transfer pricing issues should ultimately be viewed as a three-party matter and not just a two-party between the taxpayer and the tax administration initially examining the transaction.

BIAC suggests that the definition of comparability should be further refined with examples and discussions of situations that have been acceptable to OECD tax administrations under the proper facts and circumstances. For example, in the context of the performance of limited risk functional activities (e.g., limited risk distribution, limited risk manufacturing, limited risk research and

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<sup>7</sup> See Comparability Draft, page 8, par. 20 which states in relevant part:

where one would try to create the theoretical arm's length environment by asking the question, whether the conditions of the controlled transaction under review are consistent with what a reasonable independent party *would have done* if confronted with the same opportunities or set of circumstances and quantify the adjustment by reference to profits that *would have* accrued at arm's length.

<sup>8</sup> See further comments below regarding the reasons for aggregation.

development, and routine service providers), a discussion regarding how the arm's length price is primarily effected by the amount of services performed and the use of routine intangibles would be illustrative. BIAC believes that part of the natural evolution of an update on the Guidelines would include examples that the tax administrations would readily apply .

### ***Timing Issues in Comparability***

BIAC states that the application of the arm's length standard must be fundamentally based on an ex ante view where the profit (loss) associated with risk bearing is uncertain.

BIAC recognizes that the application of this approach may require testing with evidence that is not necessarily available at the time the intercompany arrangement is made. While a tax administration may avail itself of information after the filing of the return, such information should be used for determining from an audit perspective whether the taxpayer properly applied the arm's length standard. If the tax administration believes the arm's length may not have been properly applied, a final determination should be made with evidence available to the parties regarding what parties at arm's length may have done under comparable circumstances.

While BIAC recognizes some tax administrations consider an ex post view appropriate in order to properly allocate the tax base among effected tax administrations, nevertheless, such testing should ultimately be done on information available to parties dealing at arm's length at the time the intercompany arrangement occurred. Thus, information that becomes publicly available after the filing of the tax return should not be used to propose adjustments to a taxpayer's transfer pricing policy.

BIAC suggests that this view is consistent with other tax obligations of a taxpayer including those for customs and VAT. The setting of an arm's length price on an ex ante basis is consistent with these other tax reporting obligations. The OECD should be cognizant of these other obligations in setting a transfer pricing test for the arm's length standard. Accordingly, BIAC urges the OECD to continue worked aimed at reconciling the variation in application of the transfer pricing rules among other rules used for different tax obligations.

### ***Comparability Search***

BIAC suggests that the forthcoming guidance more clearly bifurcate the comparability issues between potentially comparable transactions and potentially comparable companies for application of a profits based approach.

In this regard, BIAC suggests a working group of WP6 members and taxpayers to draft illustrative guidance that may address the most common difficulties in applying the Transfer Pricing Guidelines.

The challenge in a comparability search evolves around the degree to which the comparability of the tested transaction aligns with that of the unrelated transactions. As noted in the Comparability Draft such alignment is generally lacking, particularly for complex and valuable intercompany transactions.

BIAC notes the concern for linking the search for comparables and the comparability analysis and agrees that this is an important part of a transfer pricing analysis.<sup>9</sup> However, at best only broad

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<sup>9</sup> See Comparability Draft, page 6, par. 10 which states in relevant part:

comparisons can be made with respect to the five factors of comparability because of the lack of certain non-financial information.

The existence of relevant internal comparables is a problematic analysis. BIAC agrees that proper due diligence for a transfer pricing analysis includes verifying the existence of any relevant internal comparables. BIAC agrees that the mere existence of an internal transaction does not necessarily make the transaction comparable unless it meets the material aspects of the five comparability factors.<sup>10</sup>

Rarely, however, does a company transact with a third party on the same terms as a related party. Differences among transactions with related parties and unrelated parties include:

- Volume or other size or scale factors
- Level of the market
- Temporary v. permanent relationship
- Primary sourcing v. secondary sourcing
- After-sales service, warranty services and payment terms

While BIAC agrees that internal comparables would be most useful for intercompany transactions involving intangibles,<sup>11</sup> BIAC believes very few internal CUTs for intangibles will be comparable to intercompany intangible transactions.

### *Secret Comparables*

BIAC is opposed to the use of secret comparables to make adjustments to any taxpayer's transfer pricing policy.

While BIAC recognizes the need for tax administrations to operate efficiently, the use of secret comparables is fundamentally inconsistent with the ex ante nature of the arm's length standard because of the lack of transparency from the taxpayers' perspective to test whether the tax administration is in fact applying the arm's length principles reasonably.

BIAC opposes any means to legitimize the use of secret comparables during the audit process through the use of an agent of the taxpayer who would be authorized to review the relevance of the secret comparable data. This process creates additional costs and complexities for a growing tax compliance area which needs to focus on creating additional means to increase transparency, not less. Moreover, the use of secret comparables during the MAP is inconsistent with BIAC's view that the Guidelines should be applied by the OECD tax administrations in the same manner (and the same limitations) as is required of a MNE.

If the OECD decides to allow for the continued use of secret comparables in extremely limited circumstances, it should provide specific guidelines for their use.

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Linking the search for comparables and comparability analysis is topical since many actual experiences described to date have noticed a disconnect between these two processes. This disconnect may become more frequent as searches for comparables increasingly often rely on external comparables searched on a database, with an observed tendency to focus on comparisons of financial indicia.

<sup>10</sup> See Comparability Draft, page 19, pars. 10 and 12.

<sup>11</sup> See Comparability Draft, page 20, par. 19.

BIAC is concerned about the view expressed in the Comparability Draft regarding the differences in the access of potentially comparable information where it is stated that "On the one hand, tax administrators lack much of the internal information (both quantitative and qualitative) available to taxpayers".<sup>12</sup>

If such view is true, the administrations then lack the ability to confirm the reliability of such "secret comparables" which taxpayers have for many years legitimately claimed have been improperly applied to a particular taxpayer's facts and circumstances.

BIAC suggests as a last resort that the tax administrations obtain potentially comparable information through processes that allow for public disclosure consistent with the statement that "*On the other hand, tax administrations may have access to better comparable data through use of their access powers*".<sup>13</sup> If the tax administrations do in fact have such access, they should not use secret comparables.

BIAC disagrees with the conclusion that there is an "*information asymmetry [that] has potential implications in terms of the determination of available sources of information*".<sup>14</sup>

A taxpayer should be willing to provide any information it relied upon to determine its taxable income under the arm's length standard. A tax administration may also hire experts to assist it in complicated matters where it lacks the experience of the taxpayer in pricing certain types of transactions.

BIAC agrees that information a party may obtain under the prudent business management principle may include information other than actual third party transactional data. For example, a taxpayer's business employees may be able to identify circumstances under which arm's length pricing may occur. While this information may not be as easily auditable as transactional data, it may provide a tax administration with preliminary information to determine whether a taxpayer's intercompany pricing is comparable to what would occur at arm's length.

Sources of information continue to present challenges for taxpayers and tax administrations in applying the arm's length standard. Taxpayers face the challenge of incorporating reliable information into a tax return that meets the requirements of the arm's length standard. Publicly available information contained in commercial databases allows taxpayers to demonstrate that their transfer pricing policies conform with arm's length behaviour.

The publicly available information contained in commercial databases further demonstrates the range of profits (losses) for what comparable companies earn under similar circumstances. This information allows both the taxpayer and tax administration to discuss transfer pricing with a common base of understanding which BIAC believes reduces tax controversy in most instances. Specifically, the information may support instances where short-term loss activity is consistent with arm's length behaviour due to unfavourable economic circumstances.

BIAC also supports the use of publicly available information that may be obtainable through Internet research of general arm's length pricing behaviour for specific transactions. Such information may support either the use of a transfer pricing policy developed under the prudent business management principle or from commercial databases.

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<sup>12</sup> Comparability Draft, page 24, footnote 2, first paragraph.

<sup>13</sup> Comparability Draft, page 24, footnote 2, second paragraph.

<sup>14</sup> Comparability Draft, page 24, footnote 2, last paragraph.

While BIAC supports the principles regarding alternative sources of information that could be used under the prudent business management principle, BIAC believes the inevitable downside to such transfer pricing analysis is increased tax controversy as tax administrations would have to raise more questions to understand and validate a taxpayer's application of this approach.

In this context, the inherent subjectivity of modelling an arm's length transfer pricing policy without readily available financial data may lead to increased compliance costs for all MNEs and less certainty for taxpayers and tax administrations. There are many legitimate statistical techniques that can be used to demonstrate the application of an arm's length transfer pricing model; however, most tax administrations routinely reject such methods. BIAC recommends that OECD consider expanding the types of acceptable statistical techniques that may be used to apply the arm's length standard.

With regard to the use of Standard Industry Classification ("SIC") codes in conjunction with the use of commercial databases, the appropriate use of SIC codes will depend on determining what are the material comparability factors. In some cases, use of companies in the same SIC will be appropriate; in other cases, companies that operate under comparable circumstances in a different SIC may be appropriate.

### ***Examining the Five Comparability Factors***

BIAC agrees that the five comparability factors should be considered under the facts and circumstances when applying the arm's length standard to an intercompany transaction, and that the importance of these factors will depend in part on the transfer pricing method used to benchmark a transaction.<sup>15</sup>

BIAC suggests that frequently two or more factors will be immaterial in performing a practical and cost effective transfer pricing analysis. In such cases, a brief analysis explaining why some of the five comparability factors are not material should be deemed sufficient. BIAC would suggest that accounting for all factors that may affect an arm's length price is impractical if not impossible.<sup>16</sup>

BIAC is concerned by the general view expressed in the Comparability Draft that adjustments should be made as much as possible. Most of the factors that affect the five comparability factors cannot be simply adjusted through an algebraic analysis that may apply to differences in inventory.<sup>17</sup> It must be recognized that to quantify the differences between a set of comparables and a controlled transaction the use of statistical analysis will be required. BIAC is concerned, based on experience of its members, that most tax administrations summarily reject most statistical techniques as being too complicated. Thus, OECD should consider providing examples of the proper use of statistical techniques.

BIAC generally concurs with the statement in the Comparability Draft:<sup>18</sup>

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<sup>15</sup> See Comparability Draft, page 36, par. 8.

<sup>16</sup> See Comparability Draft, page 5, par. 8 which states in relevant part:

Any proposed comparison of prices or margins should be supported with documentation allowing a broader understanding of all the conditions of the transaction being reviewed (hence the importance of the five comparability factors identified in the Guidelines);

<sup>17</sup> An inventory adjustment can be made based on short-term interest rate for the opportunity costs associated with holding extra inventory.

<sup>18</sup> See Comparability Draft, page 52, par. 26.

*It is not always the case that third party data deserve the proposed adjustments. Sophisticated adjustments may be questionable when basic comparability criteria are only broadly satisfied. For instance, it is not worth adjusting data for an identified difference in accounts receivable if in the first place comparability is likely to be materially affected because of significant uncertainties that could not be resolved in the accounting standards applied by the third parties. Comparability adjustments should only be applied to good quality comparables in order to improve their accuracy. If the search for comparables has major shortcomings, sophisticated adjustments should not be applied to create the wrong impression that the outcome is “scientific”, reliable and accurate.*

BIAC suggests that the reliability in some benchmarking analysis will be less than what is ideally sought under the Guidelines. If such benchmarking is the best available, taxpayers should still be able to rely upon it.

BIAC agrees that the extra cost to adjust the comparables is not justified in the situation where the comparables may have other material differences that cannot otherwise be adjusted.<sup>19</sup>

### *Contractual Terms*

BIAC agrees that contractual terms are an important factor to consider when the intercompany transaction is not structured in the same manner as relationships among unrelated parties.<sup>20</sup>

In particular, risk bearing within a MNE group may affect the usefulness and reliability of data available from unrelated transactions in the same industry. Since risk bearing has a significant effect on the amount of profit (loss) earned by an entity, accounting for the effect of contractual terms will frequently be important to applying the arm's length standard.

BIAC agrees that if a taxpayer does not follow the form of its intercompany arrangements as may be set forth in intercompany agreements, a tax administration may propose adjustments consistent with the taxpayer's actual behaviour.

BIAC, however, strongly disagrees with the proposition that “*where arm's length parties would not undertake the transaction as structured, it may be necessary to re-characterise the transaction to ... adjust the conditions.*”<sup>21</sup> A tax administration should not start effectively managing a MNE's intercompany transactions.

When an MNE has structured its business in a certain way, has booked the economic consequences of such structure and these books have been audited by the statutory auditors and the reporting with the relevant corporate governance bodies has been made, a tax administration should respect such structure.

A tax administration should not be able to reallocate risk bearing within a MNE if the related parties agree to such risks on an ex ante basis. For example, research and development activity is not

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<sup>19</sup> BIAC believes that the last sentence of this paragraph should be reworded as “If the search for comparables has major shortcomings, sophisticated adjustments should not be applied to create the wrong impression that the outcome is *more* reliable and accurate.”

<sup>20</sup> See Comparability Draft, pages 40 and 41, pars. 24 and 25.

<sup>21</sup> See Comparability Draft, page 41, par. 26.

necessarily a risk bearing activity. There are examples among third parties where risk of development is borne by the research and development entity and some where little or no risk is borne.

Similarly, supply chain rationalization may result in the allocation of risk bearing responsibilities within the group that would not be seen among unrelated parties because the market is inefficient in allowing for such risk transferring. Such market inefficiencies should not provide a justification to a tax administration to disregard an otherwise substantive economic risk bearing arrangement within an MNE. Also, when an MNE structures its business in a way that is not yet known by "independent parties" because it is novel, the tax administration should not reject the structure when the MNE lives up to the consequences of this structure.

### *Functional Analysis*

Focusing on the activities performed in an intercompany transaction will be important in most intercompany transactions, particularly when the transfer pricing model used considers the value provided by activities associated with the transfer of property. The functional analysis will be particularly important in framing the transfer pricing model that may be most reliably applied. Given the difficulties in adjusting for differences in risk bearing, a functional analysis will be important in identifying the least complex party to an intercompany transaction.

BIAC agrees that a "*broad-based analysis*" is essential in applying a transfer pricing comparability analysis.<sup>22</sup>

BIAC believes that such analysis can focus a transfer pricing analysis to the more important value-added activities and reduce the focus of taxpayers and tax administrations on routine activities that should not otherwise be subject to disagreement on how to apply an arm's length price. For example, a service-oriented subsidiary may be engaged in all phases of marketing activities such as general pricing to consumers, product development, promotional activities (advertising) and logistics (delivery). A fully integrated service in this context somewhat differs from many intra-group services in terms of the integration of services and thus may be more valuable.

BIAC agrees that "*quantity does not make up for poor quality of data.*"<sup>23</sup> However, BIAC emphasizes OECD's recognition that the lack of information publicly reported by third parties reduces a taxpayer's ability to make reliable adjustments to potential comparables.

To avoid favourable comparable selection, i.e., cherry-picking, taxpayers select a broad set of comparables to demonstrate that the results of their intercompany transaction is not inherently outside of the arm's length range. The use of numerous broadly based comparables allows

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<sup>22</sup> See Comparability Draft, pages 6 and 7, par. 14 which states in relevant part:

In this respect, the first step i.e. the "broad-based analysis" is an essential one. The broad-based analysis can be defined as an analysis of the industry, value drivers, competition, economic and regulatory factors and other elements to better understand the taxpayer and its environment but not yet within the context of looking at the specific transactions in question. This step helps understand the conditions of the taxpayer's controlled transaction as well as the conditions of the uncontrolled transactions to be compared.

<sup>23</sup> See Comparability Draft, page 39, par. 20.

taxpayers to avoid the tax controversy associated with “favourable selection” claims frequently made by some tax administrations.

### *Characteristics of Property or Services*

BIAC suggests that the similarity of intercompany property or services with third party property or services will not frequently be critical to reliably applying the arm's length standard.

For example, distribution activities can often be reliably tested from activities in another industry if comparable levels of activity are undertaken to distribute tangible property.

BIAC endorses the pragmatic view that a comparability analysis can be broadened (except in the context of a CUP transfer pricing method) in order to obtain otherwise unavailable reliable benchmarking data.<sup>24</sup>

However, BIAC proposes that the expansion not be limited to the next “*closest comparables*.”<sup>25</sup> In this regard, BIAC respectfully disagrees with the view that broad comparables with different types of functions can not be reliably used to benchmark a controlled transaction.

BIAC encourages OECD to consider under the prudent business management principle that the benefit from refined comparability analysis generally outweighs the additional costs.

Furthermore, the geographic span of comparables should not be limited by regional or national boundaries, *i.e.*, pan-European or Asian comparables should be acceptable in jurisdictions such as Germany or China, where local comparables are very difficult to obtain.

As such, BIAC recognizes that, in certain circumstances, the use of non-domestic comparables may compensate for the lack of country specific reliable information.

BIAC believes that the use of regional comparables should be allowed in principle – rather than subject to limitations and verified on a case-by-case basis – in regions (such as Europe) where the uniformity in the economic circumstances and the application of uniform accounting principles are likely to mitigate national differences. This approach is endorsed also in the proposal by the European Joint Transfer Pricing Forum for a Code of Conduct on Transfer Pricing Documentation for Associated Enterprises in the EU, as adopted by the EU Commission (COM(2005) 543 final)

### *Economic Circumstances*

BIAC agrees that economic circumstances may affect arm's length pricing for some intercompany transactions.

For example, changes in the business cycle or the product life cycle may affect the arm's length price of an intercompany transaction. In such situations, comparing the transaction to comparables in the same economic circumstance, everything else equal, would be critical to properly applying a transfer pricing model. BIAC agrees that an intercompany transaction subject to unique economic circumstances should be reasonably explained in documentation.<sup>26</sup>

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<sup>24</sup> See Comparability Draft, page 38, par. 15.

<sup>25</sup> *Ibid.*

<sup>26</sup> See Comparability Draft, page 42, par. 30.

BIAC is concerned that not all differences in economic circumstances have an effect on profitability let alone a predictable one. For example, differences in size of business operations (sales, assets, or number of employees)<sup>27</sup> do not necessarily result in a change in profitableness. In fact, BIAC can posit situations where increase size leads to lower profits (scale inefficiencies) as well as higher profits (ability to spread fixed costs over a larger base).

With respect to intercompany services, tax administrations should consider that an intercompany charge within a MNE will not be the same (in type or relative size) as it is for smaller and less integrated companies. The type and magnitude of costs will vary significantly between these two types of companies. Tax administrations should not query whether the amount of charges from a global MNE are appropriate solely with regard to what smaller companies may charge.

### *Business Strategies*

Business strategies affect long-term aspects of an intercompany transaction.

In this context, the use of comparables may need to account for variations in profit (loss) earnings based on such strategies. Specifically, in the case of a business strategy to penetrate a new market where the risk is borne by the distributor, comparables of companies operating under a similar business strategy will be more relevant than profit (loss) earned by established distributors in the same industry.

Business strategies often implicate the acceptance of risk within the MNE. Intercompany agreements allocating the risks associated with a particular business strategy should be respected if sufficient economic substance exists.

### *Multiple Year Data*

BIAC suggests the use of multiple year data will be based on the facts and circumstances of the intercompany transaction and for the need to test annual results for anomalies associated with unfavourable economic circumstances.

If a taxpayer's intercompany transaction provide for a long-term business relationship, the use of multi-year data demonstrating how unrelated parties may earn profit (loss) over similar time periods may be useful to demonstrate what is a range of arm's length results. For example, a distributor may be willing to earn short term losses or low profit if it can expect to earn a larger amount of profit in the future after it establishes an efficient market base.

From a tax compliance perspective, if a taxpayer's results are outside of an arm's length range of results in a particular year, an adjustment should not be proposed if the taxpayer's results are otherwise within the arm's length range of results for the multiple year. Such a perspective is consistent with the view in the Comparability Draft that multiple year data is not a statistical tool.

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<sup>27</sup> See Comparability Draft, page 41, par. 28.

## ***Aggregation of Transactions***

BIAC notes that MNEs form in part because of the need to aggregate certain transactions that cannot be efficiently performed on a disaggregated basis among unrelated parties. As such, MNEs are inherently challenged to disaggregate its array of supply chain activities into discrete increments.

Aggregation also occurs among unrelated parties. Unrelated parties dealing at arm's length will often price products and services on a bundled basis. A typical example regards the licensing of software and related computer support services. The pricing of one transaction cannot be viewed in isolation as that price is dependent on the terms of the other transaction.<sup>28</sup> Under such circumstances consideration of the entire return from the aggregated activities is consistent with the arm's length standard and should be allowed.

BIAC agrees that the use of judgment based on the facts and circumstances is the practical basis to determine how much aggregation is reasonable and should be compared to aggregation inherent in the comparable benchmarking data.<sup>29</sup>

## ***Other Issues***

### *Statistical Methods*

Given the imprecise nature of testing intercompany transactions, statistical analysis can be used to ensure that non-biased results are obtained in confirming the arm's length nature of intercompany transactions. There are a variety of statistical analyses that may be appropriate under the facts and circumstances.

There may be instances where the use of statistical analysis should be combined with qualitative analysis.

For example, within a range of results a qualitative discussion could be presented whether the low end, the mid, or high end of the range is more appropriate. BIAC would support under the proper facts and circumstances a ranking approach as suggested in the Comparability Draft.<sup>30</sup> One approach that reduces tax controversy of whether a particular comparable should be in or out (an all-or-nothing approach) is to assign weights to all the comparables but varying the weights to account for those results that appear for qualitative reasons to be more similar to the tested intercompany transaction.<sup>31</sup>

Regarding the question on how reliability of statistical methods may be improved, BIAC suggests that the statistical technique should relate to the transfer pricing method used and the facts and circumstances of the intercompany transaction.

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<sup>28</sup> In fact, this "tying" arrangement is an example where a potential internal CUT would not be reliable since the price is dependent

<sup>29</sup> See Comparability Draft, page 66, par. 13.

<sup>30</sup> See Comparability Draft, page 72, par. 17.

<sup>31</sup> For example, some data may be weighted 75%, some 50%, and the least similar at 25%.

For example, the use of an interquartile range may be inappropriate where certain qualitative distinctions raised in the comparability analysis cannot be adjusted. Instead, a discussion why the transaction should be in the upper or lower part of the arm's length range may be more instructive. On the other hand, if a tested party transaction involves limited risk bearing by the tested party a statistical analysis which reduces the volatility of the arm's length range may be appropriate. The use of a traditional standard deviation may be appropriate.

#### *Loss Making Comparables*

Regarding the use of loss-making comparables, BIAAC supports a facts and circumstances analysis. For example, a limited risk entity would not be expected to earn a loss under most circumstances and thus loss comparables should generally be excluded. On the other hand, a value-added distributor that undertakes to develop a particular market would be expected to earn short-term start up and occasional short-term economic losses throughout its operations. In such situations, loss comparables should be included if such comparables otherwise represent a going concern.

BIAAC generally agrees that a related party would not agree to a transaction where it perpetually operates at a loss. However, there are situations, as would be described in the in two of five of the comparability factors (business strategies and economic circumstances), where a short-term loss may be appropriate for a particular transaction. In such circumstances, loss comparables would be appropriate to consider; in fact, not to do so, would be inappropriate and lead to a non-arm's length outcome.