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Subject: Comments on the Proposed Revision of Chapters I-III of the TP-Guidelines

Dear Mr. Owens,

WTS AG is pleased to provide you with comments regarding the latest release of a proposed revision of Chapters I-III of the Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations dated 9th of September 2009 (Current Draft).

1. General remarks

WTS recognizes the high efforts made by the OECD, other organizations from the public and the business sector as well. We acknowledge the Current Draft as a state of the art discussion on transfer pricing theory and its practical implementation. Although WTS recognizes the profoundness of the single arguments contained in the Current Draft we miss a stringent opinion of the OECD towards the issues discussed.

Despite not having the power to bind any law court, the OECD Guidelines by now are regarded as an opinion of an expert by German tax auditors and tax courts as well. WTS knows that the same holds true in many countries, where tax law often directly refers to the OECD Guidelines.

WTS has the opinion that the Current Draft endangers the generally high judicial relevance of the OECD Guidelines since its findings are without the necessary commitment

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in certain areas. Eventually, the OECD guidelines should guide tax payers and tax offices towards a sound approach on transfer pricing issues. By now the Current Draft rather provides tax payers and tax administrations with arguments both sides can use to strengthen their positions.

We propose in the following a general approach on how to improve the structure of the Current Draft. In a next step we discuss single Chapters of the Current Draft.

2. General Approach on structuring and wording

WTS proposes to revisit Chapter III and Chapter I with respect to comparability. As before Chapter I should discuss the theory of comparability whereas the practical parts of Chapter III should form a separate Appendix.

The OECD already acknowledges that a guideline can not cover any potential case (paragraph 2.9) and that a deviation from the standards of the OECD Guideline is possible (paragraph 2.8). It might be worth revising the Current Draft under these aspects to decide whether single paragraphs are necessary or can be condensed (e.g. paragraph 3.26).

Additionally the Current Draft weakens its decisiveness by diverse references to the “circumstances of the case” indicating a possible deviation from the principles in the Current Draft (e.g paragraphs 2.11, 2.74, 2.86, 2.87, 2.93, 2.94, 2.95, 2.112, 2.120, 2.125, 2.126, 2.128, 2.133, 2.138, 2.141, 3.37, 3.42, 3.44). It might be worth revisiting these paragraphs to clarify what is a standard approach and what is the exception.

WTS proposes to include a revised paragraph 1.15 to strengthen the decisiveness of the Current Draft and later Revised Guidelines:

1.15 A move away from the arm’s length principle would abandon the sound theoretical basis described above and threaten the international consensus, thereby substantially increasing the risk of double taxation. Experience under the arm’s length principle has become sufficiently broad and sophisticated to establish a substantial body of common understanding among the business community and tax administrations. This shared understanding is of great practical value in achieving the objectives of securing the appropriate tax base in each jurisdiction and avoiding double taxation. This experience should be drawn on to elaborate the arm’s length principle further, to refine its operation, and to improve its administration by providing clearer guidance to taxpayers and more timely examinations. In sum, OECD member countries continue to support strongly the arm’s length principle. The following sections are the OECD’s interpretation of the arm’s length principle. Therefore it might be necessary to deviate from the OECD’s interpretation of the arm’s length standard when the facts and circumstances of the particular case require it. In fact, no legitimate or realistic alternative to the arm’s length principle has emerged. Global formulary apportionment, sometimes mentioned as a possible alternative, would not be acceptable in theory, implementation, or practice. (See Section C, immediately below, for a discussion of global formulary apportionment.)

This or a similar expression could allow to removing the references to the “circumstances of the single case” in the Current Draft and could strengthen the character of the OECD Guidelines as well.

3. Remarks on Chapter I – Section D Guidance for applying the arm’s length principle

a. General remarks

WTS appreciates the comparability criteria mentioned: 1) Characteristics, 2) Functional and risk profile 3) Contractual terms 4) Economic Circumstances 5) Business strategy. All characteristics will have an impact on the price/margin, which third parties would negotiate.

On the other hand there are many comparability criteria, which are relevant in practice but are not mentioned here. Some of them are volume of the transaction, size of the participating entities, date of the transaction, negotiating power, usage of consolidated vs. unconsolidated data (some of those aspects are part of Chapter III of the Current Draft). WTS discusses Chapter III below but proposes to discuss all comparability criteria in one place.

b. Theory towards a Perfect Comparable

WTS misses a theory towards a Perfect Comparable. WTS proposes to discuss how a Perfect Comparable would look like. WTS believes that there are two general concepts towards a theory of a Perfect Comparable. One is the **ex ante or stochastic theory** the other one is the **ex post or deterministic theory**. Both theories have different implications with respect to adjustments, comparability analysis, data to be applied etc. In the following we will shortly introduce both theories and their implications.

c. Ex ante or stochastic theory towards a Perfect Comparable

Under the **ex ante or stochastic theory** a Perfect Comparable will come to the identical *expected* price/margin as the tested transaction when all *systematic* comparability criteria are met. Most likely the ex ante theory will result in a differing price/margin from the ex post perspective. The ex ante theory explains ex post differences between Perfect Comparable and tested transaction with the impact of unsystematic differences of comparability criteria as well as with statistical deviations. The ex ante theory leads to the following implications:

- There can be more than one Perfect Comparable
- The ex ante theory requires adjustments only when a systematic deviation between controlled and Perfect Comparable exists

- You can work with statistical methods in order to identify whether the tested transaction lies within some kind of distribution of the comparable transactions. The interquartile range is such an approach
- You can conclude that a large sample of Perfect Comparables generally leads to better results than a small one
- You can test the impact of single comparability criteria
- You can work under the assumption, that non measurable criteria have a non systematic impact on the distribution of both comparable and tested transactions
- It is a preferred method when only limited data on comparability is available

d. Ex post or deterministic theory towards a Perfect Comparable

Under the **ex post or deterministic** theory a Perfect Comparable has to come to the *identical* price/margin as the tested transaction, when all comparability criteria are met. Differences between Perfect Comparable and tested transaction cannot incur. Therefore, an observed deviation between comparable and tested transaction has to be explained by deviations of comparability criteria. The ex post theory leads to the following implications:

- One Perfect Comparable is sufficient to conclude on the arm's length nature of the tested transaction since all Perfect Comparables will result in a single price/margin
- Deviations between tested transaction and comparable transaction lead to the conclusion that one or more comparability criterion is not met. The corresponding adjustments have to be made
- You would not expect a range of Perfectly Comparable prices/margins but only a single price/margin
- Statistical methods cannot be applied, since there is no expected variance between the tested and comparable transaction
- The ex post theory requires a very detailed functional and risk analysis
- The ex post theory is applicable when there are very few or only a single comparable and many comparability criteria can be identified and quantified

e. Conclusions on a theory towards a Perfect Comparable

The Current Draft does neither explicitly refer to the ex ante nor to the ex post theory. In many cases the Current Draft implicitly refers to the ex ante theory (e.g. arm's length range, database screening). In some cases the Current Draft seems to refer to the ex post theory (e.g. adjustments, quality of data over quantity).

WTS proposes to include a statement towards the ex ante theory. The application of the ex post theory should be the exception.

4. Remarks on Chapter II

a. Transfer pricing methods

WTS agrees to the abandonment of the last resort nature of the TNMM and Transactional Profit Split.

WTS proposes to skip any hierarchy between the applicable transfer pricing methods (paragraph 2.2.). Any obligation to select the most appropriate transfer pricing method leads to an issue of measurement. If you want to find the best of diverse methods to the circumstances of the case you will need a criterion to measure the appropriateness of those methods to the circumstances of the case. At the moment such a criterion is missing. Even if you have such a criterion the tax payer has to compare both methods with respect to this criterion.

You also need a measurement criterion to judge on the criterion of “equal reliability” of two methods. Without such criterion you cannot decide whether/when you have to use a CUP before other methods or other methods before you apply a transactional profit method. On the other hand each chosen method can be attacked since it will never be sure whether another method is “equally reliable”.

WTS concludes that any hierarchy of methods leads to unnecessary obligations of the tax payer. A tax payer should be obliged to select “one appropriate transfer pricing method” to the circumstances of the case. This principle is already stipulated in the Current Draft (paragraphs 2.7 and 2.10).

b. Transactional profit split method

WTS appreciates the elevated discussions on the applicability of the transactional profit split method. For consistency’s sake we propose to talk about “transactional profit” and “transactional profit split” instead of simply “profit” and “profit split”. WTS also appreciates paragraphs 2.78-2.80 where reference is made to the deviation of the transactional profit to be split.

WTS misses explicit reference to the peculiar functional and risk structure under a profit split agreement. Under a transactional profit split agreement all participants take over entrepreneurial functions and corresponding risk. From an economic view the participants become the joint owners of their share of the future transactional profit. Obviously a transactional profit split agreement comes very near to a shareholder relationship. This special semi-shareholder relationship has to be taken into account when identifying comparable transactions.

If you hold to the semi-shareholding relationship of a profit split agreement the most obvious split of profits would be according to the investment (cost) in the profit split.

This is a common split of profits observed e.g. under potential comparable joint venture agreements.

Investments in the profit split agreement can best be measured by contributed capitalized cost (e.g. R&D Expenses) and contributed assets. Often, but not exclusively, those assets would be the mentioned unique contributed intangibles. A split according to other allocation keys should only be appropriate when this key is correlated to investment costs and related risk.

You can conclude that under a profit split agreement there should only be a correlation between costs and value added, when those costs measure investment and corresponding risk.

WTS therefore prefers the usage of capital/ asset based allocation keys. Cost based allocation keys and other keys should be the exception.

If investment (cost) of both participants in a profit split cannot be identified, the transactional profit split method will most likely not be at arm's length by principle. WTS denies the application of the profit split on transactions where only one or neither party takes over the entrepreneurial functions.

c. Transactional net margin method

WTS recognized the efforts made for guidance on the applicability of the TNMM. WTS has the opinion that this approach takes into account the high relevance of the TNMM approach in practice.

Sometime WTS misses a more decisive opinion when the Current Draft describes a discussion on different interpretations of the arm's length principle: E.g. usage of book vs. market value (paragraph 2.138), usage of actual vs. budgeted cost (paragraph 2.136), inclusion of non operating items (paragraph 2.120). Those paragraphs should be revisited in order to clarify which interpretation is the principle and which is an exceptional application of the arm's length principle.

WTS proposes to redraft paragraphs 2.119-2.142. In many cases those sections rather sound like a valuable discussion but not as a guideline towards the issues posed.

5. Remarks on Chapter III

a. General remarks

WTS recognizes an artificial split between Chapter I and Chapter III. We refer to our above mentioned remarks. In the following WTS discusses single issues mentioned in Chapter III of the Current Draft.

b. Separate and combined transactions (paragraphs 3.9 et seqq.)

WTS appreciates paragraphs 3.9 et seqq. on separate vs. combined transactions. WTS believes that the Current Draft neglects that most tested controlled transactions are combined transactions. It is very unlikely in practice, that the price of a single good such as a screw is tested. Of practical relevance is the testing of a transaction of the yearly amount of total screw sales. WTS proposes a reference that in many cases a controlled transaction is a combined transaction. Even when the CUP method is used, the controlled transaction will be an average price in many cases. This fact makes product comparability less important. WTS proposes to take this into account when revisiting paragraph 1.40.

c. Foreign source comparables (paragraph 3.34)

WTS would include a decisive opinion that the usage of comparables of more than one country is no infringement of the arm's length criteria (e.g. paragraph 3.34).

d. Segmented/unconsolidated data (paragraph 3.36)

The Current Draft (paragraph 3.36) discusses the usage of segmented data. WTS believes that only non-segmented data should be used. It has to be ensured that the comparables do not perform more functions than performing the tested transaction. The segmentation of companywide third party data leads to practically unsolvable issues with respect to the allocation of costs and synergistic effects to single transactions (already mentioned in paragraph 1.10).

Another related issue is the usage of consolidated vs. unconsolidated data. WTS prefers the usage of unconsolidated data of independently operating entities. The usage of consolidated data leads to the same issues discussed above with respect to the allocation of group wide costs and synergistic effects to single transactions. WTS proposes to include a paragraph covering this issue.

e. Comparability criteria (paragraphs 3.42 et seqq.)

WTS misses an overlapping/link of comparability criteria (paragraph 1.38) and criteria used to include or reject potential comparables (paragraph 3.42)

f. Additive vs. deductive approach (paragraph 3.43)

WTS agrees that the additive and the deductive approach can lead to a set of comparables. If you hold to the ex ante approach towards a Perfect Comparable the deductive approach is the preferred one. It is easier to loosen or strengthen a single comparability criterion and thereby broaden or limiting the arm's length range. It is also easier to test whether a single comparability criterion has an impact on the arm's length range at all.

And of course all potential comparables are obvious, since they are the starting point of the analysis.

g. Adjustments (paragraph 3.46)

WTS misses a stringent approach towards adjustments (E.g. paragraph 3.46). WTS proposes to adjust only in case a systematic deviation between controlled and comparable transaction can be identified and quantified. If such a deviation is only expected but cannot be quantified WTS poses to refrain from adjustments. It is not sure that in such a case adjustments will improve comparability.

h. Arm's length range (paragraph 3.54)

Whether the arm's length range will result in a single figure is dependent on the ex ante/ ex post approach on comparability. If you hold to the ex ante approach towards a Perfect Comparable you will not expect a single figure. You would neither expect a dice rolling consecutively the same number.

i. Usage of loss making comparables (paragraph 3.63)

WTS misses a decisive opinion when loss making comparables can be used (paragraph 3.63). WTS proposes to use loss making comparables only when the tested party in the controlled transactions assumes a loss potential, either. The usage of the cost plus method on actual cost or TNMM in the controlled transaction would not allocate a loss potential to the tested party in the controlled transaction. Contract manufacturers are often remunerated without allocating a loss potential. No loss making comparables should be used in such a case.

WTS appreciates the opportunity to comment on the Current Draft and we hope that our comments are helpful.

Yours sincerely,

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