



The Voice of OECD Business

Paris, 15 May 2008

Re: BIAC Comments on Transactional Profit Methods

Dear Jeffrey,

Enclosed are BIAC's comments on the OECD's Discussion Draft for Public Comment on Transactional Profit Methods, dated 25 January 2008.

The BIAC comments are organised around the ten Issue Notes set forth in the OECD Discussion Draft. As a basic matter, business finds that the work of the OECD CFA WP6 in this area to be a good advancement to international taxation.

The following are themes in the BIAC comments that ought be highlighted:

- BIAC is supportive of eliminating the last resort status of transactional profit methods.
- Articulating the goal in the selection of transfer pricing method, as being the setting of the "most appropriate method" for a particular case, has prospect for helping to build clarity and reducing conflicts; however, we need to be watchful that the concept, which has connotations about comparison of several methods, not be allowed to be used to justify demands for multiple transfer pricing studies under different methods.
- BIAC believes that the key to advancement in this area is establishing and agreeing upon a process by which the taxpayer ascertains and applies the "most appropriate method". The process supported by BIAC is described on page 2 of our submission.
- BIAC also believes that the Working Party 6 should explore ways to re-enforce the related premise that a study for or use of a second or other method should not be required of the taxpayer or applied by tax authority, unless it is demonstrated that the taxpayer's method is flawed. The current indefiniteness in the area of selection process too often results in demands for multiple studies that are not necessary, are costly, inefficient, and generate disputes.

We would welcome further consultation on the subject, and would be pleased to receive any questions or comments that you may have on our comments.

Sincerely yours,

A handwritten signature in black ink that reads "P. Ellingsworth". The signature is written in a cursive style with a large initial "P" and a long, sweeping underline.

Patrick J. Ellingsworth
Chairman, BIAC Committee on Taxation and
International Affairs

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cc:
Mr. Tadahiro Asami, BIAC Secretary General
Bureau of the BIAC Committee on Taxation and Fiscal Affairs



The Voice of OECD Business

**Comments of the Business and Industry Advisory Committee
to the OECD (BIAC)**

on the

**25 January, 2008 OECD Discussion Draft on
Transactional Profit Methods**

May 2008

Issue 1: Review of Transactional Profit Methods: Status as Last Resort Methods

BIAC (i) supports the tentative conclusion in the OECD Discussion Draft on Transactional Profit Methods (the Draft) that the stigma currently in the 1995 OECD Transfer Pricing Guidelines (the Guidelines) that profit methods have last resort status be removed; supports the approach that the selection of transfer pricing method is essentially about the process for finding the most appropriate method for a particular case; and in that process supports the primacy of reliability and availability of information regarding comparable uncontrolled prices or transactions; and

(ii) recommends that the process of selection of the most appropriate method be based on a methodical, principled process with full analysis of the five comparability factors, and would thereby receive appropriate procedural deference.

- BIAC welcomes the Draft's "tentative conclusion" that a "most appropriate method" standard should guide the selection of the TPM. BIAC feels that this standard will promote the development of principles for the conduct of taxpayers and tax administrations that are responsive to the practical challenges that they respectively face in applying the arm's length principle.
- In the interest of making this standard more concrete, BIAC urges that the Guidelines be amended to equate the "most appropriate method" with that method which provides a reliable estimate of the arm's length result for the taxpayer's related party transaction(s). That method, in turn, will be the one that emerges from a methodical, principled process with full analysis of the five comparability factors, as discussed throughout the Draft.
- BIAC's recommendation for a methodical, principled process is summarized as follows:

If the taxpayer has followed a process that comprises a thorough functional analysis and a full evaluation of which method is appropriate, then the method that the taxpayer has selected should be given appropriate deference by the relevant tax administration. The method selected may be consistent with and may largely follow from the hierarchy of methods currently in the Guidelines, but this is not a requirement. In any event, if the methodical, principled process is applied, then the taxpayer should be deemed to have discharged its initial or primary burden of selecting the "most appropriate method" for evaluating its related party transaction(s) for adherence to the arm's length standard and should not be required to also demonstrate that some other method is more appropriate. Fundamental principles of the process would be (1) that, when available, methods that apply data from comparable uncontrolled prices or transactions generally would be the "most appropriate," and (2) procedurally, that both taxpayers and tax administrations would be subject to the same standard of rigor in setting or challenging a method as being the most appropriate method.

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- In addition to already being consistent with the approach taken by tax authorities in various OECD member nations, including France, Germany, and New Zealand, BIAC believes that this is eminently sound and that there are several reasons to believe it will meet the aims of the OECD Committee on Fiscal Affairs Working Party No. 6 (WP6) and the needs of the business community (as set forth below).
 - Although the exact content of this process cannot, and should not, be spelled out in advance in any given case, as a general matter, BIAC feels that it should proceed along the lines of the general framework provided in the proposed amendments to ¶ 1.68 (Draft, p. 8). To emphasize, any such guidance that the WP6 might include in the Guidelines should be based on principles rather than being prescriptive. In particular, two general principles or factors would seem to underlie any question of method selection:
 - (1) Whether the method is reliable in identifying the arm's length result (either prices or profits) for the kind of intercompany transaction at issue taking into account the degree of comparability between the controlled transaction and uncontrolled transactions; and
 - (2) The reliability and availability of information necessary to apply the method.
 - Together, these principles suggest that several different considerations will enter into the taxpayer's decision about the method to apply. Following careful attention to the functions performed, assets employed, and risks assumed by the parties to the transaction in order to establish comparability, consideration will also be given to the availability of data to apply a method, including consideration of whether there exists:
 - (i) Internal data (if any) relating to the price (in the first instance) or margin, mark-up or profitability (in the second instance) of similar transactions with third parties, and the extent to which reliable adjustments can be made;
 - (ii) External data relating to the price (in the first instance) or margin, mark-up or profitability (in the second instance) of similar transactions with third parties, and the extent to which reliable adjustments can be made; and
 - (iii) Data on any highly integrated arrangements with related parties in which risks are shared and non-benchmarkable contributions are made.
 - An important implication of these principles is that, when assessing their relative strengths and weaknesses, the various methods should not be compared with each other in the abstract. The appropriateness of a method should be determined solely with regard to its reliability in determining the arm's length result in light of the facts and circumstances of the related party transaction.
 - Furthermore, the process that BIAC envisions does not impose any requirement to use OECD pricing methods to set transfer prices, but only that the "most appropriate method" standard guide the demonstration that the *results* of a related party transaction meet the arm's length standard. The "most appropriate method" standard

applies only to test the arm's length character of an intercompany transaction. The best method for this purpose may be, but is not necessarily, the same method that was used by the parties to establish the transfer price used in the intercompany transaction. To some extent, this is reflected in the WP6's proposed amendments to ¶ 1.68b (Draft, p. 8), but BIAC would prefer that the WP6 be explicit on this point.

- Rationale for methodical, principled process for establishing most appropriate method for a particular case:
- First, for many BIAC member companies, the profit methods are no longer methods of last resort. The TNMM (applied using different net profit margin indicators, such as a markup on total costs or a return on assets or capital employed) are indeed used quite frequently, including for determining an arm's length return for commercial functions within a multinational group (e.g., using a TNMM based on the Berry ratio).
- Second, many BIAC members have found that tax authorities vary in their relative ranking of the methods under the current Guidelines. Some tax authorities agree with the considerations that led the WP6 to its tentative conclusions. Other tax authorities, however, steadfastly hold that profit methods are inherently inferior. For members of BIAC, consistent, world-wide transfer pricing policies and methodologies are necessary in order to manage transfer pricing audits and documentation requirements concerning multitudes of intercompany transactions. Variability in tax administrations' interpretation of this aspect of the Guidelines increases not only compliance costs, but also the complexity of transfer pricing audits and documentation, which burdens both taxpayers and tax administrations.
- Third, there is often little difference between the transaction and profits methods, both in their motivations and in their application. For example, there is a direct sense in which the aggregate profitability of a tested party for which a cost-based application of the TNMM is the most appropriate method can be reduced to the cost-plus markups it earns in individual transactions. This suggests that the two methods complement each other, differing only in scope, not in kind. Moreover, from a practical perspective, both kinds of method are subject to the same questions of data availability, the definition and size of the relevant range, and so on. Retaining the status quo thus seems unlikely to change the practices of taxpayers, while at the same time simply perpetuating controversies, not only between taxpayers and tax administrators, but also between tax administrators at the competent authority level. BIAC proposes that the WP6 recognize this practical reality and seek to narrow the zone of controversy.
- Fourth, adopting a "most appropriate method" standard would focus the attention of taxpayers and tax administrations where it belongs: on the *main value drivers* of the controlled transaction. For example, even as presented in the analysis of the Draft, the cost plus method has primacy over the use of the TNMM and, in particular, the selection of the Berry Ratio. However, as indicated above, both the cost plus method and a cost-based application of the TNMM are grounded on the premise that, for certain kinds of transactions, the arm's length remuneration should be based upon

the mark-up on the relevant costs uncontrolled parties would earn under comparable economic conditions. While there will remain the question as to which costs are the “main value drivers” for the transaction being analyzed, the point is that the distinction between transaction and profit methods does not clarify what the “most appropriate method” should be for such cases. Rather, the only meaningful question concerns the nature of the costs that are the value drivers in the transactions at hand. BIAC believes that this is the kind of information that tax administrations should be examining when determining whether the process the taxpayer has followed in selecting its TPM is consistent with the arm’s length standard.

- Although BIAC will provide recommendations in a separate set of responses as to how the WP6’s proposed amendments to the Guidelines would need to be modified to endorse and implement the “most appropriate method” standard as outlined above, certain language in the current Draft still stigmatizes non-transaction methods in ways that BIAC hopes the WP6 will, indeed, move away from when it revisits its amendments to the Guidelines. For example, profit methods are described as providing only an “approximation” of what the arm’s length result would be in a given transaction (see proposed amendments to ¶ 3.1, 3.2c (Draft, pp. 10, 11). Similarly, there are said to be “substantial concerns” regarding the use of the TNMM (¶ 3.53, Draft, p. 16), and that “considerable caution” must be used when determining whether the profit split method can produce an arm’s length answer (¶ 3.56, Draft, p. 17). BIAC views such remarks as entirely unhelpful, because the same cautions and concerns apply to indiscriminate use of the transaction methods.
- Lastly, BIAC urges that the WP6 refine its discussion of the profit split along the lines discussed above to emphasise that this method, like any other method, should be selected, either by the taxpayer or by a tax authority in a given case, only after a process has been followed that accounts for the five comparability factors. In particular, the current Draft’s explanation of the appropriateness of profit split methods is not clear. In the proposed amendments to ¶ 3.5 (Draft, p. 11) and in other parts of the Draft, emphasis is placed on the role that the integrated nature of the operations should play in determining whether the profit split is chosen. While this is one factor to take into consideration when deciding on whether a profit split is the most appropriate method, certainly many activities of a multinational group are also integrated, but that does not mean that a profit split will thereby be appropriate in all such cases. Rather, other factors are also important in distinguishing a situation where the profit split is appropriate, including the sharing of risks, shared interests in assets including intangible assets, and the presence of non-benchmarkable contributions being made by the parties to the arrangement. BIAC feels that these considerations should also be emphasised by the WP6.
- In this vein, BIAC believes that the WP6’s proposed amendments to ¶ 3.9 (Draft, p. 13) are right in pointing out that a reliable application and verification of a profit split requires, among other things, access to relevant data and consistency in accounting practices among the associated enterprises participating in the controlled transactions. Nevertheless, BIAC asks the WP6 to consider whether its concerns are stated too broadly, which could have the unintended consequence of creating

perceptions about weaknesses in the application of the profit split. If it is appropriate for a profit split to be applied since the parties are operating in a highly integrated, risk-sharing manner, then relevant financial information will be available.

Issue 2: Use of More than One Method (Use of a Transactional Profit Method in Conjunction with a Traditional Transaction Method, or Sanity Check)

- BIAC is appreciative of the WP6’s clear denial of a requirement to use more than one method under the arm’s length standard. It would be redundant (and inefficient) to require taxpayers to use a secondary method. BIAC thus proposes that the Guidelines be amended to clearly state that there is no requirement to have, or use, a second method, particularly a profit split, to test the arm’s length nature of taxpayers’ transfer prices. Consistent with our remarks on Issue Note 1, only if a tax authority demonstrates that the taxpayer has not met its initial burden of selecting an appropriate method for evaluating its related party transaction(s) should the issue of a different method arise, either as an alternative to the taxpayer’s selected method or as a secondary method. In addition, from our remarks on Issue Note 1, we recommend, procedurally, that both taxpayers and tax administrations would be subject to the same standard of rigor in setting or challenging a method as being the most appropriate method.
- There is also the practical danger that the WP6’s recommendation of double testing or using a secondary method could lead to an interpretation by some tax authorities that for certain transactions, double testing should systematically take place. Any requirement or suggestion of a requirement to double test or apply different methods at the transactional or documentation level is unreasonable and burdensome.
- BIAC would suggest that the Draft avoid examples of particular cases in which a secondary method might be appropriate. Including such examples only encourages tax administrations to second guess the results of primary methods or expect supporting methods even from taxpayers who have determined that their primary method is the “most appropriate method”. As an alternative to listing such examples, BIAC recommends that the WP6 simply let the “most appropriate method” standard stand on its own.
- The reference to “competing” methods in the WP6’s amendments to ¶ 1.69a (Draft, p.23) should be reconsidered. If a method works in accordance with the comparability standard, it suffices and there is no competition, as noted in the BIAC comments proposing a “most appropriate method” standard for Issue 1 above.
- BIAC also notes that the discussion of sanity checks reflects the process of case resolution in many OECD Member countries (in and out of MAP processes). BIAC would like to work with the WP6 to develop examples of how sanity checks can appropriately be utilized, consistent with the comments above.

Issue 3: Access to the Information Needed to Apply or Review the Application of a Transactional Profit Method

- BIAC agrees that information relating to the five comparability factors pertaining to a controlled transaction and relevant to aspects of the taxpayer's cost accounting methodology should be made accessible to tax authorities. BIAC believes that such a position would be equitable to both taxpayers and tax administrations.
- BIAC also notes that the WP6's suggestion that information must be provided with respect to all parties in a controlled transaction means that in the case of so-called "one-sided" transactions, taxpayers would face a mandatory requirement to produce information about related affiliates involved in the transaction that could effectively be used against the taxpayer as a sanity check of its one-sided method. This appears inconsistent with the tenor of Issue Note 2. Thus, BIAC asks that the WP6 outline careful rules for the information that tax administrations can request, perhaps incorporating the explicit "reasonableness" standard that BIAC suggested in its comments of August 2006.
- For example, BIAC agrees that allocation calculations, if relevant to intercompany pricing, should be made available to the tax authorities. However, this does not imply that it is necessary to hand over management accounts in their entirety. Allowing tax authorities unfettered access to such accounts would impose unnecessary compliance costs on taxpayers and could distract a tax authority from focusing on relevant specific transactional issues. BIAC would therefore have concerns if rights of access to cost accounting data (discussed at ¶ 54 (Draft, p. 27)) are not qualified, indeed, even more so than as they are discussed in the Draft.
- There are likely to be many situations where transfer pricing rules apply, but where a taxpayer is unable to gain access to the financial information of another entity (e.g., minority shareholding, joint venture arrangements). Where a taxpayer has adopted a reliable method to test its transfer pricing position and can support that approach with local data, it should not be asked to seek the financial information of another entity, except in exceptional circumstances.

Issue 4: Application of Transactional Profit Methods and Unique Contributions

- The concept of “non-benchmarkable” intangibles is a dramatic change from the existing Guidelines. BIAC agrees with the WP6 that, if progress is to be made on these issues, definitions need to be developed.
- Several of the new terms presented in the Draft are confusing as to the principles the WP6 is seeking to articulate. Consider BIAC’s comments regarding the following definitions in the Draft:
 - What is the difference between “non-unique” or “routine” and “benchmarkable” intangibles? Are they the same? If not, what is the difference? Was “benchmarkable” chosen over “routine” to emphasize that valuable functions that may not be qualified as “routine” can be benchmarked?
 - “Benchmarkable” functions, risks, and assets are defined as those for which “reasonably” reliable comparables exist. More clarity is requested as to what constitutes “reasonably” reliable comparables.
 - What if something is “non-benchmarkable”: does it automatically become a unique contribution or intangible? The Draft seems to imply that this is the case, but explicit commentary would be instructive. (From a practical perspective, this may not make a difference if the profit split is the “most appropriate method” for analyzing a non-benchmarkable activity).
 - The notion of a “unique contribution” seems confusing. First, a unique contribution is defined as being “non-benchmarkable” (¶ 57). However, ¶ 58 states that no specific method is prescribed for unique contributions. ¶ 59 then states that a thorough search for internal comparables should be performed for unique contributions, contradicting ¶ 57 that defines a “unique contribution” as being “non-benchmarkable”. BIAC believes that it is important to point out that there can be comparables for unique contributions, and that the statement at ¶ 59 is key.
 - What is the difference between a “unique contribution” and an intangible? ¶ 231 alludes to the difficulties in defining intangibles. Similar problems seem to arise in identifying and valuing unique contributions. Given this similarity, is the notion of a unique contribution being introduced to make it easier to argue that an entity has to be rewarded with the “residual” even if there are no intangibles?
- BIAC welcomes the WP6’s recognition that the presence of non-unique or low-value intangibles should not, in themselves, disqualify the TNMM from being selected by a taxpayer as the “most appropriate method” under its facts and circumstances. Indeed, the WP6’s observation that such intangibles may be widespread among

potential comparables (and thus not differentiating one comparable from others) comports with the experiences of BIAC's members in their searches for comparables when applying the TNMM.

- BIAC agrees with the WP6 that the TNMM can be a useful and reliable methodology for evaluating the arm's length nature of a license fee. However, consistent with its comments on Issues Note 2, BIAC urges that secondary, "sanity-check" methods be affirmatively declared as unnecessary.
- BIAC specifically recommends that para 88 dealing with the use of TNMM as a sanity check for license fees be deleted. This paragraph inappropriately endorses multiple transfer pricing reviews and also of perhaps many local variations without showing any need for them.

Issue 5: Application of the Transactional Net Margin Method: Standard of Comparability

- BIAC appreciates the WP6's apparent awareness of the difficulties and limitations BIAC's members face in obtaining the kind of reliable data that is needed to apply the TNMM. The WP6's efforts to find a position on this issue that is both "theoretically sound" and "practically workable" are encouraging.
- One specific, practical point on which BIAC had hoped that more specific advice would be given in the Draft is the use of databases. BIAC's members have had conflicting experiences with tax authorities in their acceptance of comparable company searches and analyses conducted in certain commercially-available databases. BIAC's recommendation is that the WP6 maintain a flexible approach with regard to the kinds of data, resources, and sets of comparables that a given taxpayer uses to support its conclusion that the method it has adopted is the "most appropriate" for its facts and circumstances.
- BIAC agrees with the need to prepare illustrations and explanatory language to address the points regarding aggregation / segmentation (or "portfolio approaches") made in ¶ 111 - 113. Aggregation of products is common in management reporting, and it needs to be recognized that taxpayers may not have the information to disaggregate transactions to meaningful levels of profitability.
- Illustrations 1 through 3 are interesting examples but they are not specific to TNMM; rather they illustrate common comparability issues affecting all methods using a margin, mark-up, or other profit-based approach. In addition the examples highlight comparability issues in theory, which are unlikely to be easily identifiable in practice; for example, information about the factory utilisation of comparables is unlikely to be publicly available. Practical examples would be more useful.
- As a last, general point, Illustrations 1 through 3 are useful, as they demonstrate common problems and suggest means of addressing the pertinent matters. It should be noted, however, that highly accurate data regarding such issues as factory utilisation may be difficult to obtain. In addition, BIAC would urge that the WP6 also consider including an example that deals with the issue of loss comparables.

Issue 6: Application of the Transactional Net Margin Method: Selection and Determination of the Net Profit Margin Indicator

- BIAC continues to urge that the WP6 accept a facts-and-circumstances-based test for the appropriateness of any ratio, especially “less traditional” ratios, such as the Berry ratio, a mark-up on operating expenses, or profits per employee. In this regard, BIAC agrees with the WP6 that no ratio, whether traditional or untraditional, should be applied in a “formulaic” manner, to use the WP6’s term (¶ 161). The application of any ratio must be determined only with due consideration of the underlying economic characteristics of the case at hand.
- Unfortunately, the WP6’s remarks on the appropriate indicator for “selling activities”, which are said to cover both “buy-and-sell activities” and the activities of commissionaires and sales agents (¶ 162), all but belie its own view that the facts and circumstances of the related party transactions at hand, not prescriptions about the measure of the arm’s length result to use in a given case, should inform the taxpayer’s selection of its method. If the choice of the PLI is to be based on the taxpayer’s value drivers, and if these value drivers, together with due consideration of the other facts and circumstances of the case at hand, point to a Berry ratio, then its use should be respected by tax authorities, regardless of whether the taxpayer is what might be commonly called a “sales agent”, a “pure distributor”, or some other kind of buy-sell operation. Indeed, there are sound arguments to support the use of the Berry ratio over sales-related indicators for measuring the arm’s length compensation that should be received in the kinds of cases for which the WP6 presumes that sales-related indicators are generally most appropriate.
- Importantly, the view of the WP6 presented in the Draft is that the arm’s length remuneration of such activities should generally be based on a sales-related indicator, in the absence of evidence that independent parties would agree otherwise (*ibid.*). The appropriate basis for the remuneration of selling activities presents a more subtle question that should not be addressed with sweeping presumptions about the manner of their compensation or the most appropriate method for their evaluation, even when such remarks are downplayed as only general principles. Contrary to the WP6’s view expressed in ¶ 162 of the Draft, a cost-related indicator (such as a Berry ratio or a mark-up on total selling costs) is a viable economic indicator of the arm’s length remuneration for common types of “buy-and-sell” distribution and commissionaire activities, even when they do not include additional, “significant promotion” services (¶ 162) or are not performed as an intermediary between two related parties (¶ 163).¹

¹ To be clear, BIAC agrees that a Berry ratio is appropriate for cases involving sales intermediaries like those discussed at ¶ 163. Not coincidentally, such cases reflect the basic fact pattern of *DuPont v. United States*, the case in which Dr. Berry employed the ratio of Gross margin to operating expenses to determine the arm’s length compensation that DISA, Dupont’s intermediary, “super distributor” in Switzerland, should receive. BIAC’s point is that the Berry ratio is also a viable financial indicator in cases involving sales to unrelated parties,

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- The discussion in the Draft overlooks what commissionaires and distributors (of various kinds of goods) have in common. Both entities perform routine sales and marketing services, i.e., “benchmarkable” marketing functions that are widespread among comparable enterprises, performed in varying degrees of intensity, but still similar in kind. Further, generally speaking, neither is at risk for inventory loss or obsolescence. Commissionaires do not bear this risk because they do not take title to the goods they are selling, and distributors commonly have inventory “buy-back”, price-protection guarantees or related provisions in their contracts with suppliers. Thus, the economic concern of these enterprises lies not in being compensated for this risk, but rather in covering the costs they incur in providing the services they offer, together with a profit element. In other words, their shared economic concern lies in covering their respective value-adding costs. This implies that a cost-related indicator (e.g., a Berry ratio) is a viable measure of the economic substance of transactions involving “buy-and-sell” activities and the activities of commissionaires and sales agents.² Thus, BIAC urges the WP6 to refine its discussion on this point along these lines, not only to clarify its remarks on this specific kind of case, but also in the interest of providing an example of the kinds of substantive economic considerations that taxpayers should take into account when determining the most appropriate method for its facts and circumstances.
 - Moreover, as a point of perspective, the application of the Berry ratio to sales-related activities is but one kind of case in which it provides a viable measure of arm's length results. More generally, it is appropriate to apply the Berry ratio whenever the entity or comparable being evaluated has a particular *cost structure* – namely, one that draws a distinction between pass-through expenses (non-marked up expenses) and value-adding expenses (marked up expenses). In pressing this fundamental point, Dr. Berry himself noted that advertising agencies, for example, have such a cost structure, because they pass on the cost of advertising slots to clients and receive a mark-up on the value-adding activity of procuring such slots.³ Value-adding freight forwarders also have this cost structure, for they pass on the costs of purchasing

not just intermediary sales.

² Indeed, the points raised in this paragraph suggest that companies performing comparable “buy-and-sell” functions, even in varying degrees of intensity, using comparable assets, and assuming comparable levels of risk should receive comparable levels of compensation. Although not intended to demonstrate this point, Illustration 1 (¶102) provides a clear example in which the Berry ratio would yield this conclusion. Under the assumptions of the Illustrations, in Case 1, where the distributor performs a limited marketing function, the Berry ratio would be 1.14 (Gross margin of 400 divided by operating expenses of 350). In case 2, where the distributor performs more of the same kind of marketing services and thereby incurs more in marketing expenses, the Berry ratio would be 1.15 (Gross margin of 520 divided by operating expenses of 450).

³ Dr. Berry addresses this example in his seminal article, “Berry Ratios: Their Use and Misuse”, *Journal of Global Transfer Pricing*, 47-55 (June – July 1999), at 49, which the WP had apparently consulted in preparing the Draft (since it is cited as a reference at page 52 of the Draft). BIAC urges the WP to revisit Dr. Berry’s article, which presents in very clear terms the reasons why a cost-related indicator provides a viable measure of the arm’s length remuneration for distribution activities and other activities with a similar cost structure.

cargo slots on ships, trains, etc., and receive a mark-up only on the value-adding activity of coordinating orders and procuring transportation slots. In light of this analytical depth and consistency, BIAC believes that, when applied to the right kind of facts and circumstances, the Berry ratio is a reliable tool that taxpayers and tax administrators can employ to determine arm's length results not only for certain sales-related activities, but for any activity that has similar economic characteristics. Accordingly, BIAC asks that these considerations be reflected in the WP6's subsequent work.

- BIAC agrees with the WP6's comments regarding the determination of the net profit margin as long as a consistent approach can be, and is, applied to both the tested party and the comparables. This is the difficulty. Take share options for example. The Draft states that if there are material uncertainties then third party comparables should be rejected. If information is not fully published in regard to share option costs then how can materiality be assessed appropriately?
- BIAC has noted that the WP6 has also not addressed local tax authority guidance which may conflict with OECD guidance (not Guidelines) in relation to the treatment of share option and pension costs. How are these differences to be dealt with in practice?

Issue 7: Application of a Transactional Profit Split Method: Determining the Combined Profit to be Split

- BIAAC appreciates the inclusion of its comments from 2003 concerning the need to address combined losses as well as combined profits, particularly as it relates to the WP6's flexibility on the use of gross versus net profits as the basis for the combined profits to be split. The appropriateness of the one or the other basis is clearly sensitive to the kinds of activities that are being performed by the parties to the arrangement and the contributions that they make to the profits (or losses) that arise as a result. Accordingly, it is imprudent to adopt anything other than the "most appropriate method" standard and the attention it places on the facts and circumstances of the case at hand.
- With respect to the invitation for comments on Guidelines ¶ 3.17, BIAAC will offer its views, as requested. As a preliminary thought, BIAAC notes that members of the business community have had varying experiences on this issue. Some have reached agreements with selected tax authorities to use gross profits as the basis for a profit split in a global trading operation, while others have reached agreements to use operating profit as the basis for a profit split within a global trading operation, even in the face of longstanding agreements to use gross profit (with direct tracing of certain expenses to traders' locations) as the basis for the profit split, an outcome that saves the taxpayers and tax administrations involved time and resources in accounting for local expenses. Consistent with the remarks above, such varied experiences suggest that attention to the individual taxpayer's facts and circumstances should determine the approach taken in cases generally described by Guidelines ¶ 3.17.

Issue 8: Transactional Profit Split Method: Reliability of a Residual Analysis and a Contribution Analysis

- BIAC agrees with the need for developing an appropriate definition for the term “benchmarkable.”
- BIAC generally agrees with the WP6’s apparent view that a flexible standard should be adopted for determining the appropriate profit split method (contribution or residual) in a given case. For example, when the amount of non-benchmarkable functions or intangible assets provided by the parties are significant compared to benchmarkable functions or intangible assets, a contribution profit split will likely be the most appropriate method. For transactions in which there are relatively more benchmarkable functions or intangible assets provided by the parties that are included in the integrated operations, the residual analysis will likely be the more reliable method by ensuring that routine, benchmarkable functions receive arm’s length compensation, thereby focusing the analysis on the relative contributions of non-benchmarkable functions or intangible assets provided by the parties.
- The profit split methods also force taxpayers and tax administrators to pay particular attention to the main value drivers of the transaction at issue. To take the example cited in BIAC’s 2006 remarks, a residual profit split can be particularly useful for splitting profits between the trading function and the capital function of financial services businesses. The party(ies) that receive shares of the residual profits (losses) should contribute to the arrangement in ways that are not captured by its (their) receiving a routine return for the functions they perform. Such a determination requires that taxpayers carefully evaluate which activities or resources are central to the success of the arrangement, which is exactly the kind of evaluation that the “most appropriate method” standard should lead taxpayers to conduct.
- BIAC asks that more clarity be provided as to the circumstances under which gross profit (or anything between operating and gross profit) can be split. For example, ¶ 194 states that “the choice of what measure of profits to use should depend on facts and circumstances of the case, in particular on the comparability (including functional) analysis of the controlled transactions under review.” In practice, gross profit is often split because it is difficult and unreliable to identify the relevant operating expenses for each legal entity, even when applicable regulations may require splitting operating profit.
- Does the term “benchmarkable” functions, assets or risks mean “routine”? The definition used by the WP6 does not provide any clarification and indeed confuses the issue by using the phrase “reasonably reliable comparables”. Both terms are vague and need further explanation. BIAC considers that either benchmarkable functions are referred to as routine or that the definition is turned around and refers to “non-benchmarkable functions. . . for which reasonably reliable comparables do not exist.”

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- BIAC also suggests that the amendments to the Guidelines include references to the division or allocation of losses as well as profits, a position that, as noted above, it has urged in the past. That said, BIAC also asks that the WP6 consider adding language that would address those cases arising in the context of global trading operations in which appropriate comparables (such as hedge-funds) have been identified for transactions wherein a trader or similar services provider splits profits with a provider of capital who bears the risk of losses (as discussed in the OECD's *Report on the Attribution of Profits to Permanent Establishments (Part III – Global Trading)*, primarily at ¶¶ 161-4).
 - Lastly, BIAC suggests that it may be appropriate to reconsider the “safe harbour” prohibitions which were included in the 1995 Guidelines, given that experience suggests that perceptions exist of “reasonable” margins or mark-ups.

Issue 9: Application of a Transactional Profit Split Method: How to Split the Combined Profit

- The experience of BIAC members is that concepts relating to combined-income analysis are becoming more common in transfer pricing discussions between tax administrations and taxpayers. Combined income is a concept that is pertinent to the use of profit splits, as well as to the separate but related issue of allocations to PEs. BIAC submits that there are two issues here, each of which creates issues that need to be addressed.
 - (1) How to determine combined income? Multinational taxpayers today use a variety of financial accounting software programs for local country purposes, regional and global integration or accumulation, and other functional purposes. Such programs may be used for management, financial accounting, and/or tax reporting purposes. In addressing the subject of combined income, tax administrations and taxpayers both experience difficulty in determining how the combined income or loss shall be determined. This includes both elements of income and expense. BIAC proposes that guidance needs to be provided on this important preliminary issue.
 - (2) Splitting the combined income. BIAC agrees with the WP6 that it would be unproductive to set forth a prescriptive list of the criteria or allocation keys that could or should be used to divide profits between related parties. In this regard, BIAC further agrees that the only specific guidance that could be provided on this point is that taxpayers tie their criteria or allocation keys to the “main value driver(s) of [their] transactions”. Although the language in the Draft is not inconsistent with BIAC’s previous remarks on this point, BIAC believes that language could be formulated that would endorse the importance of contractual arrangements in determining the location of intangibles and capital as this relates to the selection of allocation keys for splitting combined profits. Not only do BIAC’s members use contractual arrangements as the cornerstones of their transfer pricing policies, especially those with global application, but BIAC believes that, in the absence of evidence to the contrary, contractual terms often provide clear evidence of where key activities are performed, risks are assumed, and value is created. Thus, giving deference to existing contractual terms would provide a sound, predictable basis for transfer pricing policies that can be applied consistently by tax administrations.
- In principle, BIAC also considers that the mechanism to split profits should also apply to losses, and the potential for the mechanism to result in counter-intuitive splits when there is a loss rather than a profit should be avoided. If parties are not prepared to share a loss then it may be inappropriate to apply the profit split method.

Issue 10: Other Methods

- BIAC believes that the significant expansion of allocation keys in Issue Note 9 in the context of profit splits is indicative of the overall flexibility available to taxpayers who feel the need to use what have heretofore been viewed as “other” methods when those methods are determined by the taxpayers as the “most appropriate methods” for their facts and circumstances.
- BIAC agrees with the WP6’s conclusion that, whichever method is adopted, be it a transaction method, a profit method, or some other unspecified method, the underlying question is whether that method is the “most appropriate” for the taxpayer’s facts and circumstances, a determination that should be based upon a thorough analysis of the five factors of comparability.
- BIAC is not averse to the WP6’s view that taxpayers should include reasons for their rejection of recognised methods in favour of an “unspecified” method. The recognized methods are the mainstay of the Guidelines because they typically provide consistent, reliable measures of the arm’s length results in many different cases, but not necessarily in all cases. Accepting this point does not mean, however, that a taxpayer cannot use a different method if it is the “most appropriate” in its case. What it does mean is that, in the interest of developing sound, consistent transfer pricing principles and practices for the benefit of both tax administrations and taxpayers, the onus is on the taxpayer to provide evidence of the economic factors that would distinguish its case from the many others for which a recognized method is “most appropriate”.
- BIAC suggests that the OECD comment in ¶ 250 concerning the continuing reasonableness of the global formulary apportionment comments in the Guidelines should be reconsidered. These comments were made before the evolution of global trading methodologies, and long before the flexibility being introduced into the Guidelines by these Issue Notes, especially Issue Note 9. As such, the global formulary apportionment method is no longer relevant.
- With regard to the comment in ¶ 250 concerning the continuing reasonableness of global formulary apportionment, BIAC agrees that the global formulary apportionment method, as discussed at Guidelines ¶¶ 3.58 – 3.74, is not a general viable alternative to the arm’s length principle. In reflecting upon this point, however, BIAC would welcome comments from the WP6 on those contexts in which profit-split methods resembling formulary approaches might be appropriate, particularly in the context of global trading operations, and, especially, as such operations are carried out by branches and subsidiaries (Article 7 cases and Article 9 cases). Although formulary approaches might be the most appropriate method in only rare cases when global trading takes place through subsidiaries, tax authorities have been working with members of the business community to explore the use of formulary-apportionment models in cases where global trading takes place through subsidiaries that are dependent agent permanent establishments of a given capital provider (giving rise to

a case in which both Articles 7 and 9 apply). Guidelines ¶¶ 3.58 – 3.74 were promulgated before the evolution of global trading methodologies, and long before the flexibility being introduced into the Guidelines by these Issue Notes, especially Issue Note 9. Thus, in light of these developments, a second look at these sections would be appropriate.