BAKER & MCKENZIE

January 8, 2010

Mr Jeffrey Owens

Centre for Tax Policy and Administration (CTPA)
OECD
2, rue André Pascal
F-75775 Paris Cedex 16
France

Dear Mr. Owens,

the members of the Baker & McKenzie Amsterdam transfer pricing practice ("Baker & McKenzie") are pleased to provide the following comments in response to the OECD Centre for Tax Policy and Administration's public invitation to comment on the series of proposed revisions to Chapters I-III of the Transfer Pricing Guidelines for Multinationals and Tax Administration (hereinafter referred to as "the Proposed Revisions"), released on 9 September 2009.

Baker & McKenzie welcomes the OECD's efforts in arriving at a more contemporary set of guiding principles for the application of the arm's length standard.

In this letter, we have provided a series of comments or suggestions in order to, in our view, further improve the Proposed Revisions.

Sincerely,

Antonio Russo
Transfer Pricing Partner

Clive Jie-A-Joen
Director of Economics

Margreet Nijhof
Transfer Pricing Partner

On September 9, 2009, the Organization for Economic Cooperation and Development ("OECD") released the Proposed Revisions of Chapters I-III of the Transfer Pricing Guidelines for Multinationals and Tax Administration.

We hereinafter provide our comments[1] on the Proposed Revisions.

Preliminary Comment

The introduction to the Proposed Revisions (page 2) notes that the Proposed Revisions is the outcome of the work by Working Party No. 6 of the CFA ("WP6"). WP6 in turn reviewed the current Chapters I and III "based on the experience acquired since 1995 by tax administrations and taxpayers in the application thereof." Moreover, the introduction notes that the Proposed Revisions "represent an important update of the existing guidance."

Comments:

- The OECD Transfer Pricing Guidelines for Multinationals and Tax Administration (the "OECD Guidelines") have become a source of increasing importance since its publication for many multinational enterprises ("MNEs") and tax authorities alike, including OECD member countries and non-member countries. To illustrate, many MNEs have relied on the OECD Guidelines to date to design their transfer pricing policy and to prepare their documentation. Likewise, many tax authorities have directly incorporated the OECD Guidelines in their domestic transfer pricing legislation by either explicitly incorporating the OECD Guidelines by reference, or by indirectly incorporating the OECD Guidelines by drafting the domestic transfer pricing rules based on principles found in the OECD Guidelines.
- Taking into account the current role of the OECD Guidelines, the comments in the introduction to the Proposed Revisions and the proposed changes themselves, it begs the question whether the Proposed Revisions will be only effective prospectively to transactions entered into after the finalization of the revisions, or whether taxpayers should anticipate that the Proposed Revisions will be relevant upon finalization to all intercompany transactions during open years.
- Because of the potential ambulatory interpretation of the OECD Guidelines to Article 9 of the OECD Model Tax Convention, we strongly urge that the final revisions include a statement that the final revisions only apply prospectively to transactions entered into after the finalization of the revisions. In particular, MNEs should not be held to the new and increased comparability requirements of any final revisions with respect to transactions entered into during open years. If not, it is easy to envision situations where taxpayers are currently under the impression that they have prepared proper transfer pricing documentation based on the OECD Guidelines, only to be rejected upon audit based on the increased comparability standards. This would lead to inequitable situations, in addition to creating great uncertainty for many MNEs.

[1] The authors wish to express their gratitude to Pawel Wroblewski (Economist, Baker & McKenzie Amsterdam) and Omar Moerer (Financial Analyst, Baker & McKenzie Amsterdam) for their valuable input.

Chapter I. The Arm's Length Principle

A. Introduction

The Proposed Revisions have generally maintained the Section A - Introduction paragraphs 1.1 through 1.4 reaffirming the arm's length principle as the international transfer pricing standard that OECD member countries have agreed to.

Comments:

- The unequivocal reaffirmation of the arm's length principle is applauded by the authors of this letter. Although in today's global economies, the OECD member countries constitute a minority of the countries in which MNEs have related party transactions, it is critical for the OECD member countries to take a strong position on the importance of the arm's length principle as the one-and-only transfer pricing standard where both OECD member governments and non-OECD member governments may push back at times on the application of the arm's length principle and the guidelines for its application. Moreover, the OECD's efforts to be inclusive in its annual meeting and reach out to non-OECD member representatives is in our view a laudable effort to contribute to a more certain international business environment for MNEs.

The only modification to the Introduction Section A of Chapter I is contained in paragraph 1.5. The revised paragraph 1.5 no longer includes the statement that "tax administrations should bear in mind that MNEs from a managerial point of view have an incentive to use the arm's length principle to be able to judge the real performance of their different profit centres."

Comments:

- The authors regret the deletion of the statement for various reasons and would recommend that the statement be re-inserted or re-addressed as suggested below. It has been our experience that for many MNEs, management control objectives do play a role in setting transfer pricing policies. Accordingly, from our perspective, it is not useful to downplay the importance of management control objectives.
- On the other hand, it has also been our experience that the presence of management control objectives at times has been seen as inconsistent with the selected transfer pricing method. This is an incorrect view by tax administrations of management control objectives. We therefore recommend that the statement be re-inserted and in addition clarified that the presence of management control objectives should not be seen as evidence of non-arm's length behaviour. Instead, any finding of non-arm's length behaviour should be based on a comparability analysis.

B. Statement of the Arm's Length Principle

The Proposed Revisions introduce a few substantive changes to the Section B (i). Paragraph 1.6 introduces the term "comparable uncontrolled transactions" as a new term that will also be added to the Glossary. More importantly, paragraph 1.6 clearly elevates the importance of the comparability analysis not only by placing more emphasis on the comparability analysis and providing more specific guidance, but also by stating that the comparability analysis is "at the heart of the application of the arm's length principle." The newly introduced paragraph 1.7 places some counterweight to the issue of comparability by emphasizing the need for a balanced approach taking into account the need for reliability on the one hand and the taxpayer and tax administration burden on the other hand. Moreover, revisions to paragraph 1.13 acknowledge that it is "important not to lose sight of the objective to find a reasonable estimate of an arm's length outcome based on reasonably reliable information." Finally, paragraph 1.11 acknowledges the uniqueness of transactions within MNEs by stating that "[t]he mere fact that a transaction may not be found between independent parties does not of itself mean that it is not arm's length."

Comments:

- The need for a balanced and reasonable approach is absolutely critical for MNEs for several reasons not the least of which the ability to manage in practice transfer pricing risks to enhance certainty without being excessively burdened by transfer pricing requirements. We therefore consider that it is critical to continue to emphasize the need for a balanced and reasonable approach.
- We anticipate though that tax authorities will rather quickly loose sight of the need for a balanced and reasonable approach, in particular in light of the increased comparability requirements and the comparability analysis requirements that are introduced by the Proposed Revisions.
- We therefore would recommend that in addition to reiterating the statements supporting a balanced and reasonable approach, the OECD Guidelines also consider in the future alternative "safe harbour" approaches for certain (low-value and routine) transactions to counterbalance the increase in transfer pricing compliance burdens the average MNE will face. MNEs should not be required to adhere to the same compliance standard for all intercompany transactions, in particular where in many cases, a significant amount of the volume of the intercompany transactions are routine in nature. This in turn would allow for a proper allocation of transfer pricing resources by taxpayers and tax administrations.
- Finally, we agree with the acknowledgement in paragraph 1.11 that although MNE transactions may be different from transactions between independent parties, that this of itself does not mean that the transaction is not arm's length. This is a critical statement taking the discussion away from why related parties have entered into a particular transaction and instead focusing on the terms of the transaction that has been undertaken.

C. A Non-Arm's-Length Approach: Global Formulary Apportionment

In addition to re-affirming the arm's length principle, the Proposed Revisions continue to reject the global formulary apportionment. The Proposed Revisions do not introduce any new reasons for rejecting the global formulary apportionment.

Comments:

- The Proposed Revisions have properly moved the discussion from the transfer pricing methods discussion to Chapter I. The continued rejection of the global formulary apportionment is critical for MNEs for the same reasons as it is critical to re-affirm the arm's length principle. Member and non-member countries continue to introduce new transfer pricing rules. International consensus, whether formal or informal, on the use of the arm's length principle is critical to contribute to an international business and taxation environment where certainty and predictability are key.

D. Guidance for Applying the Arm's Length Principle

The first few paragraphs on the "Significance of the comparability analysis and meaning of 'comparable'" (paragraphs 1.33 through1.37) have remained in substance largely unchanged. The one revision of interest is the one relating to adjustments in paragraph 1.35, which now states the following:

> *Where there are differences between the situations being compared that could* ***materially*** *affect the comparison, comparability adjustments must be made,* ***where possible****, to improve the reliability of the comparison.* (emphasis added)

The original statement was as follows:

> ***In all cases****, adjustments must be made to account for differences between the controlled and uncontrolled situations that would* ***significantly*** *affect the price charged or return required by independent enterprises"* (emphasis added)

Comments:

- The Proposed Revisions appropriately soften the standard from "in all cases" to "where possible." This change supports the balanced approach emphasized in paragraph 1.7.
- Under the Proposed Revisions, the requirement to adjust is triggered where there are differences that materially affect the comparison, whereas currently, an adjustment is required where the differences significantly affect the price charged or return required. The term "materially" is left undefined and is not illustrated through examples. This leaves a significant amount of room for interpretation on both the taxpayer and tax administration's side.

The next few paragraphs of the Proposed Revisions introduce the most significant changes to Chapter I by providing greater detail to the factors determining comparability. In general, the added guidance is welcomed by the authors.

The newly introduced Paragraph 1.38 emphasizes that that examination of the five comparability factors is by nature two-fold, i.e., it includes an examination of the factors affecting the taxpayer's controlled transactions and an examination of the factors affecting uncontrolled transactions." The newly introduced Paragraph 1.38 also restates the concept of "reasonably reliable comparable"

Comments:

- We appreciate the upfront emphasis that a comparable must not be "perfect" but "reasonably reliable." As noted below, the Proposed Revisions do not define "reasonably reliable."
- Based on our experience, a significant amount of transfer pricing audit defense activity focuses on the selection and/or rejection of the comparables selected by the taxpayer. Therefore, additional guidance on the term and application of "reasonably reliable" is desirable.
- That said, we believe that the emphasis on the use of "reasonably reliable" comparables will be of help to MNEs in defending their choice of comparables and therefore acknowledge the importance of emphasizing the concept.

Paragraphs 1.40 and 1.41 of the Proposed Revisions provide new guidance regarding the first comparability factor (Characteristics of property or services), acknowledging in paragraph 1.40 that this factor must be given more or less weight depending on the transfer pricing method. Moreover, the Proposed Revisions also state in paragraph 1.41 that "[i]t may be acceptable to broaden the scope of the comparability analysis to include transactions involving products that are different, but functionally similar." The Proposed Revisions limit this in turn by cautioning the use of large categories (e.g., industry codes). The Proposed Revisions go one step further by also cautioning against "database dumping" in paragraph 1.50 by emphasizing that data quantity does not make up for lack of data quality.

Comments:

- The acknowledgement that product differences may not be critical where the transactions are functionally similar will be helpful to MNEs in selecting reasonably reliable comparables.
- Moreover, we agree that the practice of "database dumping" is not recommended nor a reliable approach.
- That said, paragraph 1.41 by requiring a determination whether more reliable data is available and referencing the concept of "closest comparable" moves away from the concept of "reasonably reliable comparables." By using terms such as "closest comparables" a ranking of comparables in introduced rather than sticking to the concept of "reasonably reliable comparables." We strongly urge that any such references to a ranking of comparables be excluded from the final revisions in favour of the concept of "reasonably reliable comparables."

The Proposed Revisions also unequivocally emphasize the need for a detailed functional analysis as part of the guidance relating to the second comparability factor. For example, paragraph 1.44 has deleted the phrase that "[i]t may also be relevant and useful in identifying and comparing the functions performed to consider the assets that are employed or to be employed." Instead, the Proposed Revisions now clearly state that an evaluation of the assets used should be considered in the functional analysis. The Proposed Revisions in paragraph 1.48 also seem to assume that taxpayers have prepared documentation to support the functional analysis, while in the prior version no reference to documentation was prepared (instead, a claim on risk allocation is made by the relevant parties).

Comments:

- We recommend that any references to documentation are used carefully in the Proposed Revisions such that the documentation references to illustrate a particular point do not turn over time into documentation requirements.

The Proposed Revisions relating to contractual terms introduce a new paragraph 1.53 noting that information about contractual terms may be more or less critical depending not only on the transfer pricing method applied but also depending on the type of controlled transaction, distinguishing between high-value licensing transactions and (low-value) back-office services transactions.

Comments:

- The explicit reference to the level of detail regarding this comparability factor based on the type of transaction supports an approach by the authors also suggested above relating to less detailed comparability analysis for low value transactions as compared to high value transactions. A similar approach for all comparability factors would allow MNEs and tax administrations to properly focus their resources on non-routine high-value transactions rather than being burdened with increased comparability and compliance requirements for all transactions. We therefore recommend that the final revisions explicitly acknowledge the use of simplified comparability analysis for low value transactions.

The guidance relating to the fourth comparability factor (Economic Circumstances) has been expanded significantly by the introduction of three new paragraphs (1.55 – 1.57) referencing economic, business or product cycles and geographic markets. More importantly, paragraph 1.57 discusses the use of multiple-country comparability analysis.

Comments:

- Paragraph 1.57 on multiple-country comparability analysis proceeds extremely cautiously as drafted in allowing on the one hand multiple-country comparability analysis but at the same time limiting such analysis by stating that "there are also numerous situations where an MNE group offers significantly different ranges of products or services in each country, and/or perform significantly different functions in each of these countries … In these latter situations, the recourse to a multiple-country approach may reduce reliability. While non-domestic comparables might be acceptable where they satisfy the requirements described at paragraph 3.34, this should not be interpreted as permitting the systematic use of regional searches ….”

- The limiting statement repeatedly references “significantly different” and by doing so leaves open the door to easy comparability challenges by local tax inspectors where MNEs have relied on regional comparables after a detailed comparability analysis. Emphasizing the need for local comparables by using highly subjective terms such as “significantly different” leave MNEs exposed to great uncertainty and potentially subject to an unreasonable burden in documenting their intercompany transactions.

Chapter II. Transfer Pricing Methods - Part I Introduction

A. Selection of the most appropriate transfer pricing method to the circumstances of the case

In the Proposed Revisions the OECD departs from the current hierarchical approach by adopting the “most appropriate method rule”. In paragraph 2.1 of the proposed Chapter II the following is included:

> *No one method is suitable in every possible situation and the applicability of any particular method need not be disproved. The selection of a transfer pricing method always aims at finding the most appropriate method for a particular case. For this purpose, it should take account of the respective strengths and weaknesses of each of the OECD recognised methods; of the appropriateness of the method considered in view of the nature of the controlled transaction, determined in particular through a functional analysis ;of the availability of reasonably reliable information (in particular on uncontrolled comparables) in order to apply the selected method and / or other methods; and of the degree of comparability of controlled and uncontrolled transactions including the reliability of comparability adjustments that may be needed to eliminate differences between them.*

In paragraph 2.2 of the Proposed Revisions, the OECD however clarifies that, ceteris paribus, there is still a clear preference for the traditional transaction methods over the transactional profit methods. *Verbatim*:

> *As a result, where, taking account of the criteria described at paragraph 2.1, a traditional transaction method and a transactional profit method can be applied in an equally reliable manner, the traditional transaction method is preferable to the transactional profit method.*

Further, paragraph 2.7 reads:

> *The guidance at paragraph 2.1 that the selection of a transfer pricing method always aims at finding the most appropriate method for each particular case does not mean that all the transfer pricing methods should be analysed in depth or tested in each case in arriving at the selection of the most appropriate method.*

Comments:

- We appreciate the Proposed Revisions. We would welcome additional guidance on how to appropriately document the selection of the most appropriate transfer pricing method, however.
- In particular, we believe that the clarification contained in paragraph 2.1 (i.e.: [t]he applicability of any particular method need not be disproved) may, from a practical

perspective, lose its significance and, de facto, taxpayers will be induced to demonstrate that all methods that are not selected are inappropriate rather than limiting themselves to showing the appropriateness of the one method that is selected.

- Further, the implicit hierarchy in methods set forth in paragraph 2.2, may still result in tax administrations demanding justification for not selecting one of the traditional methods when a transactional profit based method is regarded as being most appropriate, in light of, for instance, objective and material limitations in obtaining sufficient information for the application of traditional methods.
- We therefore recommend revising the language (of paragraphs 2.1, 2.2, 2.4 and 2.7) placing emphasis on what could be regarded as a "reasonable effort" in selecting the most appropriate method. In other words, allowing for a "rule of reason" whereby taxpayers can evidence that a reasonable amount of effort has been applied in identifying the most appropriate method documenting the selection of a particular method without having to justify the disqualification of the methods that are not selected. Reference is also made to our comments below in relation to paragraph 3.5 of the Proposed Revisions.

In paragraph 2.3 the OECD discusses situation in which traditional profit methods are found to be more appropriate than traditional transaction methods and the OECD has included the following example

> *One example is where, considering the functional analysis of the controlled transaction under review and an evaluation of the comparable uncontrolled transactions, it is found that a net profit margin analysis is more reliable than a gross margin analysis, e.g.* ***because there are material differences in functions between the tested and the uncontrolled transaction which are reflected only in operating expenses below the gross margin level****.* (emphasis added)

Comments:

- We suggest revising the wording, of the highlighted sentence: one could actually question the real comparability of the indicated comparables. If the differences in functions are to be considered as material, reclassification of costs is insufficient to adjust for comparability. We therefore recommend to clarify this example or to exclude it from the Proposed Revisions.

In paragraph 2.4 the OECD states that the transactional methods may not be applied automatically simply because there are difficulties in obtaining data.

Comments:

- The issue of data availability, or lack thereof, has been one of the drivers behind the increased usage of transactional profit methods and particularly the TNMM. Although we agree on the principle, we however suggest revising the language indicating that in absence of a "reasonable effort" in identifying usable information, lack of data cannot represent a sufficient justification to dismiss application of a traditional method.

In paragraph 2.8 the OECD discusses the use of transfer pricing methods not described in the Guidelines ("other methods"):

> *Moreover, MNE groups retain the freedom to apply methods not described in these Guidelines (hereafter "other methods") to establish prices provided those prices satisfy the arm's length principle in accordance with these Guidelines. Such other methods should however not be used in substitution for OECD-recognised methods where the latter are appropriate to the facts and circumstances of the case. In cases where other methods are used, their selection should be supported by documentation including an explanation of why OECD-recognised methods were regarded as non-appropriate or non-workable in the circumstances of the case and of the reason why the selected other method was regarded as providing a better solution.*

Comments:

- In our view the proposed wording of paragraph 2.8 substantially and without apparent justification departs from the current wording of paragraph 1.68, increasing the burden of documenting the choice and application of other methods. We would like to express concern in relation to all those circumstances where the use of other methods is either required or dictated by common practice (e.g. valuation analyses, financial transactions tested adopting "build-up" approaches, derivative instruments etc.). We feel that having to disqualify all of the OECD recognized methods when dealing with such transactions creates an excessive burden.

B. Use of more than one method

In paragraph 2.10 of the Proposed Revisions, the OECD confirms that taxpayers (and tax authorities) are not required to perform analyses under more than one method. Paragraph 2.10 also states:

> *However, for difficult cases where no one approach is conclusive, a flexible approach would allow the evidence of various methods to be used in conjunction.*

Comments:

- We agree in principle that, especially in complex cases, a primary method and a corroborative analysis may improve the reliability of the results. However, we recommend stressing that also under those circumstances there is no obligation to document the application of more than one method.

Chapter II. Transfer Pricing Methods – Part II: Traditional transaction methods

The Proposed Revisions introduce no substantive changes to this Section.

Comments:

- In our view a discussion of the strengths and weaknesses of the respective traditional transaction methods should be included in a fashion similar to Part III on transactional profit methods.

Chapter II. Transfer Pricing Methods - Part III: Transactional profit methods

B. Transactional profit split method

ii Strengths and weaknesses

In paragraph 2.63 of the Proposed Revisions, strengths and weaknesses of the transactional profit split method are discussed:

> *The main strength of the transactional profit split method is that it can offer a solution for highly integrated operations for which a one-sided method would not be appropriate. For example, see the discussion of the application of profit split methods to the global trading of financial instruments between associated enterprises in Part III, Section C-1 of the Report on the Attribution of Profits to Permanent Establishments that was approved by the Committee on Fiscal Affairs on 24 June 2008 and by the OECD Council for publication on 17 July 2008.*

Comments:

- In general, we appreciate the cross reference to the OECD Report on the attribution of profits to permanent establishments. In that respect we would like to point out that certain care should be placed in not necessarily expanding the scope of application of notions, such as the significant people functions notion, into a context where separate legal entities are involved.

We appreciate the additional wording and guidance provided by the OECD with respect to qualitative and quantitative value chain analysis based on internal data and information, when dealing with transactional profit split methods. The additional language does in our view provide further support to existing practices. Reference is made to paragraphs 2.65, 2.72, 2.73, 2.74, 2.88, 2.95 and 2.99.

We appreciate the emphasis put by the OECD in paragraphs 2.82 and 2.84 of the Proposed Revisions on the avoidance of hindsight by tax administrations in dealing with the application of a transactional profit split method.

> *When a tax administration examines the application of the method used ex ante to evaluate whether the method has reliably approximated arm's length transfer pricing, it is critical for the tax administration to acknowledge that the taxpayer could not have known what the actual profit experience of the business activity would be at the time that the conditions of the controlled transaction were established.*
>
> *However, care would need to be exercised to ensure that the application of a transactional profit split method is performed in a context that is similar to what the associated enterprises would have experienced, i.e. on the basis of information known or reasonably foreseeable by the associated enterprises at the time the transactions were entered into, in order to avoid the use of hindsight.*

Comments:

- In this respect, it would be important to clarify that, under a "reasonable effort rule", information on events contemporaneous to the controlled transaction, but which becomes available or known after the transaction has taken place, should not be considered (reference is also made to paragraph 3.73).

We appreciate the additional guidance provided by the OECD in paragraphs 2.86-2.92 of the Proposed Revisions on how the combined profit is to be split and on the allocation keys that can be applied.

We welcome the inclusion of paragraph 2.94 in the Proposed Revisions in which the OECD provides examples of possible sources of comparable uncontrolled transactions that can assist in determining the criteria to split the profits.

C. Transactional Net Margin Method

In paragraph 2.100 of the Proposed Revisions the OECD emphasizes its preference for internal comparables.

> *This means in particular that the net margin of the taxpayer from the controlled transaction (or transactions that are appropriate to aggregate under the principles of paragraphs 3.9-3.12) should ideally be established by reference to the net margin that the same taxpayer earns in comparable uncontrolled transactions, i.e. by reference to "internal comparables".*

Comments:

- As acknowledged by the OECD in paragraph 1.13 of the Proposed Revisions, tax payers can encounter difficulty in obtaining information regarding independent parties but also with regard to related parties especially considering information asymmetry and constraints in dispersing critical and strategic information also among related parties. Therefore, we recommend the OECD to again follow a rule of reason, i.e., indicate a threshold at which a reasonable amount of effort has been put in identifying internal comparables. Reference is also made to our comments below in relation to paragraphs 3.20 through 3.23.

We welcome the language and guidance regarding the contribution of unique intangibles in an inter-company transaction and how this affects the selection of the most appropriate method, i.e., paragraphs 2.101 – 2.103 of the Proposed Revisions.

In paragraph 2.104 the OECD describes that a particular strength of the transactional net margin method is that net margins are less affected by transactional differences than is the case with price, as used in the CUP method. The following example has been included by the OECD:

> *Differences in the functions performed between enterprises are often reflected in variation in operating expenses. Consequently, this may lead to a wide range of gross profit margins but still broadly similar levels of net operating margins.*

Comments:

- We refer to our comments to paragraph 2.3 of the Proposed Revisions.

We agree with the wording of paragraph 2.105 of the Proposed Revisions, whereby a two sided approach should ideally be followed also when applying a one-sided method.

> *Similarly, it is often not necessary to state the books and records of all participants in the business activity on a common basis or to allocate costs for all participants as is the case with the transactional profit split method. This can be practically advantageous when one of the parties to the transaction is complex and has many interrelated activities or when it is difficult to obtain reliable information about one of the parties.*

Comments:

- We would welcome additional guidance from the OECD on the level of analysis that would be required under a two-sided approach when dealing with the "non-routine" entity taking part to the transaction, as under those circumstances a two sided approach could entail a particularly burdensome exercise.

We welcome the rule of reason as included by the OECD in paragraph 2.110 of the Proposed Revisions.

> *That being said, it is recognized that in practice the level of information available on the factors affecting external comparable transactions is often limited. Determining a reliable estimate of arm's length outcome requires flexibility and the exercise of good judgment.*

Comments:

- We recommend that above rule of reason will be adopted as generally as possible, i.e., pertaining to the comparability analysis as a whole, including selection of methods, and not specifically to the application of the TNMM.

In paragraph 2.131 the OECD deals with the issues that arise when dealing with intercompany transactions that are closely linked.

> *A net profit margin indicator to sales is sometimes used to determine the arm's length price of purchases from a related party for resale to third party customers. In such cases, the sales figure at the denominator should be the re-sales of items purchased in the controlled transaction under review. Sales revenue that is derived from uncontrolled activities (purchase from unrelated parties for re-sale to unrelated parties) should not be included in the determination or testing of the remuneration for controlled activities, unless the controlled and uncontrolled activities are so closely linked that they cannot be evaluated adequately on a separate basis.*

Comments:

- The OECD uses the example in which a related entity is engaged in sales as well as purchase activities. In general we welcome the inclusion of this particular example. However we recommend expanding these considerations also to situations where, otherwise apparently unrelated transactions, should be encompassed under the transfer pricing policy. One example could be represented by service agreements locally negotiated with unrelated parties on products distributed on an intercompany basis.

Paragraph 2.138 states:

> *"In cases where the net profit is weighted to assets, the question arises how to value the assets, e.g. at book value or market value."*

Comments:

- Also with reference to paragraphs 2.86-2.92, we would like to emphasize that careful consideration should be given to valuation issues (e.g. book value vs "mark-to-market") especially in relation to intangible and financial assets.

We welcome the inclusion of the Berry ratio as one of the profit level indicators, considering its broad use and significance especially under specific circumstances where sales operations should be regarded in fact as a provision of a service: reference is made to paragraphs 2.140 – 2.142 of the Proposed Revisions.

Chapter III. Comparability Analysis

General comment

- As a general comment, the authors would like to submit that the proposed Chapter III should precede Chapter II, following the logic whereby the selection and application of the most appropriate method cannot take place in absence of a well-founded comparability analysis.

A. Performing a comparability analysis

The Proposed Revisions state that the objective of conducting a comparability analysis is to identify the most reliable comparables. It is not required to conduct an exhaustive search of all potential sources of comparables, since it is recognized that it can be a burden to perform comparables searches and information on third party transactions is frequently lacking. In this respect, the Proposed Revisions introduce the new term "reasonably reliable comparables", which is defined as "the most reliable comparables in the circumstances of the case." Moreover, the Proposed Revisions indicate that making reasonable efforts in conducting comparables searches does not constitute a safe harbor in case more reliable comparables are identified, however.

Comments:

- It is appreciated that the Proposed Revisions indicate that "perfect comparables" are difficult to identify and very often depend on the specific facts and circumstances of the case. The question arises, however, what the term "reasonably reliable" means.

The 10-step process of performing a comparability analysis is introduced in the Proposed Revisions (paragraphs 3.5 and 3.6) whereby the "typical sequential order" consisting of the 10-step process (or a similar process) is regarded as "good practice". It is appreciated that the Proposed Revisions provide that the 10-step process is not mandatory to follow (nor that going through the process provide a guarantee that the outcome will be arm's length). However, we would like to note the following observations:

Comments:

- It is likely that upon introduction of an OECD endorsed process such process will become the only accepted approach for performing a comparability analysis and that following a different or slightly deviating process will quickly be regarded as being unacceptable by tax authorities. This would in practice mean that on many occasions the freedom of taxpayers to choose, structure and support their transfer pricing systems will be limited to the OECD endorsed approach;
- Arguments can be made that this newly proposed process will ultimately increase compliance costs and the accompanying documentation burden for taxpayers;
- A different less burdensome process may be appropriate for routine transactions / activities;
- Applying the proposed 10- step process will require specialized knowledge in the field of transfer pricing economics resulting in increasing compliance costs. Hence, it should be contemplated whether SMEs can be excluded from this OECD stipulated approach;
- It is worthwhile to elaborate on what other similar processes are also considered as good practice or that there is flexibility in applying the 10-step process. We fear that tax administrations and taxpayers may differ regarding the interpretation of what constitute similar processes.

As to the prescribed approach itself and assuming that the prescribed approach would be maintained, we would like to make the following observations:

Comments:

- The order of Step 1 and Step 2 may be considered as being inconsistent with actual practice because the years to be covered under an analysis may in fact determine outcomes of the broad based analysis of the taxpayer's circumstances. Moreover, one could conclude that Step 1 is not necessary, since the same considerations are also included within Step 3 where the controlled transactions are analyzed.
- It appears to us that the order of Steps 5 and 6 may need to be changed, because it would be most practical (and efficient) to choose the most appropriate method and tested party before determining the available sources of external comparables.
- The Proposed Revisions go as far as to suggest that the 10-steps process is not a linear one, but that it may be necessary to perform steps 5 to 7 frequently until the most appropriate method is chosen. This is because the available information on comparable uncontrolled transactions has an impact on the choice of the method. Our view is that choosing the most appropriate method applying the above process results in fact in the Best Method Rule of the US transfer pricing regulations, which is an undesired outcome. This is also inconsistent with Paragraph 2.7 of the Proposed Revisions that states that selecting the most appropriate method does not imply that all methods should be analyzed in depth or tested.

- We believe that Step 10 can be regarded as strongly intervening in the transfer pricing planning and control processes within a MNE. Our view is that it is the business of the MNE itself to organize their transfer pricing planning and control mechanisms. We therefore suggest deleting Step 10.

The Proposed Revisions provide that some qualitative information on the comparability factors and in particular the functional analysis of the non tested party is nevertheless required in applying a one-sided method. However, we would like to note the following observations:

Comments:

- As acknowledged in paragraph 3.23 and as already outlined in our comments to paragraph 2.100 of the Proposed Revisions, we envisage a practical difficulty in collecting this qualitative information. In fact, we feel that the current wording of the Proposed Revisions will increase the burden and uncertainty for taxpayers in preparing transfer pricing documentation and economic analyses. Even if it seems that no detailed qualitative analysis of the non-tested party is required in this scenario (but seems nevertheless required) an important consideration to make is what will constitute "some qualitative information".
- In case the most appropriate method is the profit split method, a two-sided method, taxpayers should provide tax administrations with detailed information (both financial and qualitative information) on the foreign related party. We would like to comment that such information of the foreign entity may be difficult to collect amongst others due to confidentiality related matters.
- In general, arguments can be made that there is information asymmetry between independent enterprises meaning that sufficiently detailed data is often not be available in the context of third party transactions while the OECD expects that such information is available and considered for purposes of analyzing inter-company transactions.
- We would strongly recommend that the OECD explicitly clarifies that only information that is relevant to the controlled transactions is requested (so that the burden on MNEs is not unnecessarily increased). We also recommend that this issue is more closely addressed by the OECD.

The Proposed Revisions provide for a requirement that information on "other controlled transactions carried out by the same or other MNE group" may be considered as being useful in the risk assessment phase.

Comments:

- Why would information on controlled transactions of other MNEs be used to analyze the controlled transactions of a particular MNE? Arguments can be made that such statement is inconsistent with the arm's length principle. We suggest this paragraph is excluded from the wording or alternatively that the first sentence of Paragraph 3.25 is deleted.

The Proposed Revisions rightly suggest that commercial databases should be used objectively. We also appreciate that the Proposed Revisions provide that quality is more important than quantity when employing commercial databases (reference is made to paragraph 3.32 and to paragraph 1.50). However, the Proposed Revisions propose to refine the commercial database search with other publicly available information to increase the reliability of the analysis.

Comments:

- It is recommended to provide certain additional guidance as to what extent other publicly available information should be considered when undertaking steps to increase the reliability of the analysis. Taxpayers should not be required to search for all possible other publicly available information. We generally feel that although reference is made to the need to take into account the costs and compliance burden for taxpayers it often happens in practice that the tax authorities rarely consider that a valid concern.

We appreciate that the Proposed Revisions provide that the regional benchmarks are not automatically rejected just because they are not domestic.

We appreciate that the Proposed Revisions provide that it is unfair for tax administrations to make use of secret comparables.

Comments:

- We feel that in a scenario where taxpayers are requested to invest significant amounts in documenting and supporting their intercompany prices in a professional manner, it is simply unfair to confront taxpayers with secret comparables against which they cannot defend themselves.

The Proposed Revisions present detailed guidance on performing comparability adjustments (i.e. Step 8 of the 10-steps process of performing a comparability analysis). Moreover, in order to make sure that comparability adjustments are transparently conducted, the Proposed Revisions stipulate that information is needed on i) the reasons for the adjustments, ii) an explanation of the adjustments, iii) how the adjustments were calculated, iv) how the results of each comparable changed, and v) how the adjustment improves comparability.

Comments:

- We would like to comment that documentation of the above information would likely be disproportionately burdensome, if one considers the time and efforts needed to do so (unless if the comparability analysis involve a material comparability adjustment and in case of a specific audit).

Annex III of the Proposed Revisions provide a practical example of calculating working capital adjustments.

Comments:

- Note that describing a particular way to calculate such adjustments may render other approaches invalid in practice.

The Proposed Revisions provide that although working capital adjustments are often observed in practice, it is indicated that they should not be made automatically, because adjustments should only be made if comparability is improved.

Comments:

- This leaves room for different interpretations regarding the acceptability of such adjustments.

We welcome the recognition of statistical tools (e.g., the inter-quartile range or other percentages) in the Proposed Revisions to increase the reliability of the analysis, since these tools are frequently applied in practice.

The authors of this letter welcome the language contained in paragraph 3.69 on year-end compensating adjustments. We feel this is a very important development in providing recognition to a fundamental step in applying especially the transactional profit methods.

The Proposed Revisions consider that data from years following the year of the transaction may be relevant in analyzing transfer prices (e.g. for comparing product life cycles of controlled and uncontrolled transactions) but use of hindsight should be avoided (reference is made to paragraph 3.73).

Comments:

- We agree that use of hindsight should be avoided as much as possible. Reference is made also to our comments above in relation to paragraph 2.82 and 2.84.

Paragraph 3.80 provides that it is not required to conduct an exhaustive search of all possible relevant sources of information when performing a comparability analysis. The Proposed Revisions further indicate that taxpayers and tax administrations should exercise judgment in assessing whether reasonably reliable comparables have been identified.

Comments:

- Although the above remarks are welcome, we feel that such a statement will be insufficient balance against the detailed 10-step comparability analysis process described in Chapter III of the Proposed Revisions.

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