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Steven P. Hannes
Attorney at Law
shannes@mwe.com
+1 202 756 8218

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VIA EMAIL: Jeffrey.owens@OECD.ORG

Mr. Jeffrey Owens
Director of OECD
Centre for Tax Policy and Administration

Re: 2009 *Proposed Revision of Chapters I-III of the Transfer Pricing Guidelines*

Dear Mr. Owens:

This letter is in response to the request from the Centre for Tax Policy and Administration of the Organisation for Economic Co-Operation and Development ("OECD") for comments on the September 9, 2009 OECD *Proposed Revision of Chapters I-III of the Transfer Pricing Guidelines ("Proposed Revision")*. The *Proposed Revision* addresses transfer pricing issues in three chapters for the OECD's *1995 Transfer Pricing Guidelines for Multi-National Enterprises and Tax Administrations ("Guidelines")*.

This letter sets forth the comments of the Transfer Pricing Discussion Group (the "Group") on the *Proposed Revision*. In a letter dated May 6, 2008, the Group previously commented on the OECD's January 25, 2008 *Transactional Profit Methods Discussion Draft for Public Comment ("Discussion Draft")*, which is relevant to the *Proposed Revision*. The Group also participated in the November 18, 2008 OECD consultation on the *Discussion Draft* just mentioned as well as on the May 10, 2006 OECD series of related draft issues notes on comparability.

Introduction

The Group commends the OECD for the *Proposed Revision*. The *Proposed Revision* is the latest product from the OECD in an effort to modernize the *Guidelines*. The *Proposed Revision* is of considerable scope and importance; it takes into account transfer pricing advances of the past 15 years, addresses pricing subjects the OECD has not heretofore covered in depth, and revises prior key OECD positions on matters such as the appropriate role for profits methods and the associated topic of whether there should be a relatively rigid hierarchy for choosing a transfer pricing method. Drafting the *Proposed Revision* was undoubtedly a challenging undertaking. The Group believes that in many respects the *Proposed Revision* meets the goals of member states of the OECD and taxpayers. The Group recommends that, as discussed below, many of the explanations and positions taken in the *Proposed Revision* should be adopted when the OECD finalizes Chapters I-III of the *Guidelines*.

At the same time, and in part because of the magnitude of the clarifications, changes, and enhancements for the *Guidelines* in the *Proposed Revision,* the Group is of the view that there is room for more progress in several areas. As is explained further below, parts of the *Proposed Revision* can and should be improved and the Group offers suggestions towards that goal.

The Group's suggestions and comments are based on the collective experience and knowledge of its members. The Group consists of multi-nationals based in the United States and other countries. Participants in the Group undertake a wide range of activities that are subject to the rules of transfer pricing, including research and development, licensing, manufacturing, distribution, electronic commerce, and a wide variety of services.[1] The industries represented in the Group include automotive, consumer nondurable goods, chemicals, media, industrial equipment, news, pharmaceuticals and technical information.

Topics for Which the OECD Should "Stay the Course"

There are many positions taken in the *Proposed Revision* that are commendable and that should be adopted when the OECD finalizes Chapters I-III. Among the best aspects of the *Proposed Revision*, some of which are carryovers from the existing *Guidelines,* are the following:

- "The mere fact that a transaction may not be found between independent parties does not of itself mean that it is not arm's length."[2] "Restructuring of legitimate business transactions would be a wholly arbitrary exercise the inequity of which could be compounded by double taxation created where the other tax administration does not share the same views as to

[1] As members of the Group are not principally engaged in the banking industry, its comments do not address transactions such as global trading of financial instruments.
[2] Paragraph 1.11 of the *Proposed Revision*.

how the transaction should be structured."[3] These are clear statements of a principle that should be retained in the *Guidelines* and consistently adhered to by tax authorities.

- The *Proposed Revision* usefully reiterates the shortcomings of global formulary apportionment approaches and rightfully emphasizes that such approaches "should not be confused with the transactional profit methods discussed in Part III of Chapter II."[4]

- A helpful new statement contradicts arguments made by some that "the relative lack of accuracy of the functional analysis of possible external comparables might be counterbalanced by the size of the sample of the third party data . . . ."[5] As the *Proposed Revision* correctly states, "quantity does not make up for poor quality of data producing a reasonably reliable analysis."[6]

- The *Proposed Revision* succinctly describes a goal of the analytical process for transfer pricing as involving the selection of "reasonably reliable comparables" and the "most reliable comparables."[7] As discussed further below, however, the Group believes the OECD should further clarify and emphasize how the identification and adjustment of the best

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[3] Paragraph 1.63 of the *Proposed Revision.*
[4] Paragraph 1.18 of the *Proposed Revision*.
[5] Paragraph 1.50 of the *Proposed Revision*.
[6] *Ibid*.
[7] Paragraphs 2.1 and 3.2 of the *Proposed Revision*.

comparables should generally precede and therefore inform the selection of the most appropriate transfer pricing "method".

- The *Proposed Revision* helpfully states that although "the selection of a transfer pricing method always aims at finding the most appropriate method for each particular case … [this] … does not mean that all the transfer pricing methods should be analyzed in depth or tested in each case in arriving at the selection of the most appropriate method."[8] Transfer pricing rules are already burdensome and they should not require taxpayers to identify and analyze every potential type of comparable or method.

- The *Proposed Revision* appropriately removes the "method of last resort" stigma from the use of certain profit methods.[9] However, and as discussed below, the *Proposed Revision* should be edited to avoid giving the incorrect impression that all methods – including theory-based profit splits – are created equal in terms of their reliability.

- The *Proposed Revision* helpfully acknowledges that where both parties to a transaction "contribute unique and valuable assets," profit split may be chosen whereas that should not ordinarily be the case "where one party to the transaction performs only simple functions and does not make any

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[8] Paragraph 2.7 of the *Proposed Revision*.
[9] Paragraph 2.3 of the *Proposed Revision*.

significant unique contribution."[10] As discussed below, however, the Group recommends that the OECD tighten the constraints on the use of theory-based profit splits by dropping the reference to "ordinarily" and otherwise precluding the use of such profit splits in circumstances in which one of the parties does not contribute unique and valuable intangibles. The Group also questions the potential application of profit split in circumstances in which the intangible assets are not legally protected.[11] If the intangibles are not legally protected can they be valuable, let alone more valuable than the routine intangibles that most companies possess?

- In discussing profit split, the *Proposed Revision* usefully points out that this method can divide either losses or profits depending upon the results in a particular year.[12] Among the helpful contributions to the *Proposed Revision's* discussion of profit split are statements concerning the use of differing profit and loss allocation keys based on various factors and the observation that an "essential part" of profit split is "to identify what intangible assets are owned by each party to the transaction and what their relative value is."[13]

[10] Paragraph 2.63 of the *Proposed Revision*.
[11] Paragraph 2.90 of the *Proposed Revision.*
[12] Paragraph 2.71 of the *Proposed Revision*.
[13] Paragraph 2.90 of the *Proposed Revision*.

- The Group generally concurs with the observations on the practical role of the taxpayer's internal data in cases in which profit split is determined to be the most appropriate method.[14]

- The Group commends the observation that in order to select and apply the most appropriate transfer pricing, "the process for selecting and applying a transactional net margin method should not be less reliable than for other methods." As the *Proposed Revision* explains further, "the typical process for identifying comparable transactions . . . or any equivalent process designed to ensure robustness of the analysis should be followed . . . just as with any other method."[15]

- There are many instructive comments about the determination of net profit, including the need to exclude non-operating items and certain exchange gains and losses.[16]

- The Group appreciates the recognition that a common and appropriate source of transfer pricing information is commercial databases, and that it can be acceptable to perform searches for potential comparables in such databases on something other than a country-by-country basis.[17]

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14 Paragraphs 2.95 to 2.98 of the *Proposed Revision*.
15 Paragraph 2.110 of the *Proposed Revision*.
16 Paragraphs 2.119 to 2.145 of the *Proposed Revision*.
17 Paragraphs 3.30 to 3.34 of the *Proposed Revision*.

- The Group agrees with the comment that it is inappropriate for a tax administration to try to enforce its view of the correct transfer pricing using secret comparables or data that the tax authority cannot or will not disclose to the taxpayer.[18]

- The Group endorses the observation that "the identification of potential comparables has to be made with the objective of finding reasonably reliable data, recognizing that they will not always be perfect."[19] The Group supports the *Proposed Revision* view that in many circumstances the search for comparables may require a "pragmatic solution," including the use of third parties that may have "different business strategies, business models or other slightly different economic circumstances . . . [or that are] . . . in other geographical markets . . . ." The Group concurs that the "choice among these various options will depend on the facts and circumstances of the case, and in particular on the significance of the expected effects of comparability defects on the reliability of the analysis."[20]

- While the Group understands the observation that "an independent enterprise would not continue loss generating activities unless it had reasonable expectations of future profits," the Group believes that special

[18] Paragraph 3.35 of the *Proposed Revision*.
[19] *Ibid.*
[20] Paragraph 3.37 of the *Proposed Revision*.

> attention should be given to the comment that there should "not be any overriding rule on the inclusion or exclusion of loss-making comparables." As the *Proposed Revision* states, "it is the facts and circumstances surrounding the company in question that should determine its status as a comparable, not its financial result."[21]

The above list of positions in the *Proposed Revision* that the Group applauds is not all inclusive. As should be apparent from the above list there is much in the *Proposed Revision* with which the Group concurs, and that the Group recommends that the member states retain, as the OECD moves towards finalizing new Chapters I-III for the *Guidelines*.

As also indicated in the preceding discussion, the Group believes that even certain positive elements of the *Proposed Revision* would benefit from further work and revisions.

Provisions That Require Adjustments or Changes in Direction

The *Proposed Revision* contains many new and revised paragraphs for the *Guidelines*. The scope and significance of the proposed changes is considerable. As indicated by the supportive comments made above, the massive effort that produced the *Proposed Revision* has been successful in many respects. In the view of the Group, there remains, however, room for improvement on important subjects. For instance, there are

[21] Paragraphs 3.63 and 3.64 of the *Proposed Revision*.

parts of the *Proposed Revision* that the Group believes should be revised if the OECD's member states are to achieve the objectives of providing guidance that will reduce controversy and improve compliance with the arm's length standard of transfer pricing. The Group's suggestions in this regard are organized under the following headings:

- Reinforcement is Needed for Respecting the Taxpayer's Transactions
- The OECD Should Narrow the Proposed Scope for Profit Split
- Greater Emphasis on Types of Comparables Rather Than on Types of Methods
- The OECD *Guidelines* Should Highlight That There Basically Are Only Three Types of Comparables/Benchmarks
- The OECD *Guidelines* Can Improve Their Guidance by Deemphasizing the Use of Traditional Phrases and Adopting Other References
- The *Guidelines* Should Emphasize and Illustrate the Significance of "Relative" Reliability
- The *Guidelines* Should Further Illustrate How to Make Adjustments to the Comparables
- Cautionary Remarks About Ranges and Statistics

1. Reinforcement is Needed for Respecting the Taxpayer's Transactions.

Toward the beginning of the *Proposed Revision's* discussion of the arm's length principle, there are references to Article 9 of the OECD Model Tax Convention and to tax authorities determining whether "a re-writing of the accounts of associated enterprises is authorized under Article 9 . . . ."[22] There is a reference to determining the "quantum" of any re-writing of accounts. These proposed references to "rewriting

[22] Paragraph 1.7 of the *Proposed Revision*.

accounts" should be amended to indicate that the intention is to allow tax authorities to change the amounts of income or expense, etc. of related party transactions where that is supported by application of the arm's length standard, as opposed to possibly rewriting any other elements of the taxpayer's books and records, such as the taxpayer's contracts. Such added clarifications would be consistent with other statements in the *Proposed Revision* and in other parts of the *Guidelines,* such as those noted on page 3 of this letter, to the effect that a taxpayer's related party arrangements and contracts should be respected unless their substance contradicts their form.

The Group observes that under the *Proposed Revision* the "pro-respect" statements already in the *Guidelines* remain subject to an exception that is, in the view of the Group, too broad. The problematic exception, which needs to be deleted, would allow a tax authority to ignore the form and substance of a taxpayer's arrangements when:

> the arrangements made in relation to the transaction, viewed in their totality, differ from those which would have been adopted by independent enterprises behaving in a commercially rational manner and the actual structure practically impedes the tax administration from determining an appropriate transfer price.[23]

Taxpayers and OECD member states have recently considered and debated the meaning of this exception in the context of the OECD's work on the transfer pricing aspects of business restructurings. As the member states' instruction for the work on business restructurings was to develop that topic in the context of the *Guidelines* as written, it may be out of scope for the business restructurings work to recommend a

[23] Paragraph 1.64 of the *Proposed Revision* (old paragraph 1.37).

change to paragraph 1.37 of the *Guidelines*. It is our understanding that this constraint does not apply to the work of Working Party No. 6 on proposed revisions for Chapters I-III of the *Guidelines*.

The Group recommends that Working Party No. 6 eliminate the above referenced exception to the general rule of respecting the taxpayer's transactions where their substance is consistent with their form. There are a multitude of arrangements that unrelated parties enter which cannot be captured in any meaningful database or model. Practical experience reveals that that variability of arrangements and terms is great. As written, the exception opens the door to speculation and theorizing on what transactions "would have been adopted" by third parties. Experience informs the Group that there can be, and likely will be, at least as many such theories as there are "theorizers."

The exception's additional requirement of a tax authority having to claim that the taxpayer's actual structure practically impedes the tax authority from determining an appropriate transfer price offers, in practice, little or no protection. It is easy for a tax authority to make such a subjective, self-serving claim, and subjective standards are difficult to review. U.S. dictionary meanings of the word "impede" include both to delay and to bar. What a tax authority can do "practically" adds to the vagueness and subjectivity of the exception and is out of place as a standard to be used in deciding a person's tax liability under the law.

The exception is the source of a highly contentious type of transfer pricing controversy between taxpayers and governments; *i.e.*, when governments do not accept a taxpayer's arrangements, even when their substance complies with their form.[24] Thus, the best course for the OECD to take to remove this unnecessary source of controversy is to delete the above-referenced exception.

The Group recognizes that this suggestion may go too far in the views of some member states and in this sense may be unrealistic. An alternative, in the view of some members of the Group, is for the OECD *Guidelines* to state that if a tax authority wants to ignore or override the form and substance of a taxpayer's arrangements then it bears the burden of proof of establishing that: (1) independent enterprises behaving in a commercially rational manner consistently make arrangements, in the circumstances of the taxpayer's related party transactions, that differ materially from the arrangements made between the taxpayer and its affiliate(s); and (2) the primary purpose of the taxpayer's arrangements, including their transfer pricing, was to avoid tax.

Under the first part of the test, a tax authority might "disrespect" or override for transfer pricing purposes a taxpayer's arrangements in which the substance follows the form, only if the tax authority identifies objective evidence of probative value from actual third party transactions that the taxpayer's arrangements differ materially from what consistently occurs in the marketplace. If there is evidence that in similar circumstances unrelated parties make a variety of arrangements, then such marketplace variations indicate flexibility and do not provide a basis for failing to respect the taxpayer's

[24] Another related source of unnecessary and contentious conflict concerns the notion that governments can examine realistic alternatives that differ from the taxpayer's arrangements. See Paragraph 1.67 of the *Proposed Revisions.*

arrangements. In all events, if a tax authority only has a theory as to how independent enterprises should behave, then that would not be sufficient to satisfy the first requirement. In such circumstances the tax authority could still challenge the amount of the related party compensation paid or received, but it would be obligated to respect the taxpayer's arrangements as the taxpayer structured them, keeping in mind that their substance followed their form.

This alternative is consistent with other important principles in the *Guidelines.* "The mere fact that a transaction may not be found between independent parties does not of itself mean that it is not arm's length."[25] "Restructuring of legitimate business transactions would be a wholly arbitrary exercise the inequity of which could be compounded by double taxation created where the other tax administration does not share the same views as to how the transaction should be structured."[26]

The alternative also adheres to a fundamental principle of enforcing the arm's length standard by utilizing and placing weight on evidence of marketplace arrangements, not on theories of what those arrangements might be or should be. Thus, the above alternative would allow tax authorities to challenge and "rewrite" a taxpayer's arrangements – even though the substance follows their form – only in tax avoidance-driven situations where the tax authority has hard evidence that the taxpayer's arrangements differ materially from what third parties consistently do in similar circumstances in the marketplace. This approach allows tax authorities to enforce

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[25] Paragraph 1.11 of the *Proposed Revision*.
[26] Paragraph 1.63 of the *Proposed Revision.*

compliance with the arm's length standard while reducing the uncertainty and unnecessary controversy that the *Guidelines* already generate under paragraph 1.37, and that the *Proposed Revision* would continue.

2. The OECD Should Narrow the Proposed Scope for Profit Split. The *Proposed Revision* unfortunately, and perhaps unintentionally, notes too many opportunities for the frequent (and in the Group's view, inappropriate) use of profit split. For example, paragraph 2.3 states that transactional profit methods, which include the OECD's profit split,[27] can be more appropriate than traditional transaction methods where it is found that a "net-profit margin analysis is more reliable than a gross margin analysis… ."[28] This delphic statement is not persuasive.

The *Proposed Revision* gives additional examples of what the *Proposed Revision* considers appropriate uses of the OECD's profit split, such as where each of the parties contributes "significant unique intangibles" or where there are "highly integrated activities". Even in those cases where one party to the transaction performs only simple functions and does not make any significant unique contributions, the *Proposed Revision* only goes so far as to say that profit split would "ordinarily not be used" or

[27] As discussed below in sections 5 and 7 of this letter, there are qualitatively different types of profit split available for transfer pricing: one relies on evidence of terms and conditions of arrangements or contracts between third parties and the other splits related party profit-based on theory. The former can be far more reliable than the latter. The *Guidelines* currently do not adequately distinguish between the two types. The *Proposed Revision* appears to be primarily discussing the second type when using the labels transactional profit methods or transactional profit split. The following paragraphs of this letter use the phrase the "OECD's profit split" to refer to the second type of profit split (*i.e.*, theory-based).

[28] Paragraph 2.3 of the *Proposed Revision.*

"typically would not be appropriate".[29] Thus, the *Proposed Revision* describes a broad spectrum of acceptable applications of profit split. The Group believes this expansive and open-ended scope for the OECD's profit split is neither consistent with the arm's length standard nor otherwise advisable.

Proposed Chapter II, Part III explains different measures of profits when applying the OECD's profit split. As indicated in Annex I, and acknowledged elsewhere in the *Guidelines* and *Proposed Revision*, the OECD's profit split operates in part or entirely without the benefit of information from comparable marketplace transactions between third parties. When only the "residual profit" of the affiliates, rather than their entire profit, is split, then only the residual component is divided without the benefit of marketplace information. (The "basic returns" of the two affiliates are determined based on information from unrelated party transactions or unrelated persons in the marketplace.) The division of the residual profit is based on factors such as the relative intangible asset expenditures of the related parties involved, or on the basis of other allocation keys using the related parties' internal information. If there are no "basic functions," or if "basic returns" cannot for some other reason be determined, then the OECD's profit split relies entirely on allocation keys and internal data of the affiliates rather than on marketplace information.

The *Proposed Revision* calls for profits to be split "on an economically valid basis that approximates the division of profits that would have been anticipated and reflected in an

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[29] Paragraph 2.63 of the *Proposed Revision.* (*Emphasis supplied*.)

agreement made at arm's length."[30] Unfortunately, in the absence of marketplace evidence of how third parties actually split profits in similar circumstances, there can and will be differing opinions on what is "economically valid." There also can and will be various unsubstantiated theories and opinions about whether the basis chosen for splitting the profits between the affiliates approximates what the third parties "would have anticipated."

These non-marketplace aspects and other handicaps of the use of OECD's profit split are widely understood. For these reasons, the *Guidelines* have to date appropriately and severely restricted the use of profit split. Notwithstanding this knowledge, and as an unnecessary consequence of the manner in which the *Proposed Revision* moves away from a rigid hierarchy, the *Proposed Revision* leaves an impression that under future *Guidelines* the OECD's profit split will or can be used widely. If this impression is accurate, then the *Proposed Revision* will unnecessarily add to the uncertainty and controversy in transfer pricing. Increasing the use of the OECD's profit split is unlikely to enhance the reliability of transfer pricing.

The Group notes that the *Proposed Revision's* broad endorsement of profit split has already been perceived as encompassing OECD support for formulary apportionment,[31] even though the *Proposed Revision* goes out of its way to distinguish global formulary apportionment from the OECD's transactional profit methods, including the OECD's

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[30] Paragraph 2.70 of *Proposed Revision*.
[31] "Can Formulary Approach Fit Into Arm's Length Confines? Formulary Advocate Dubs OECD Draft Chapters a Significant Step," *Tax Management Transfer Pricing Report*, 12/3/09 (Vol. 18, No. 14), p. 757.

profit split.[32] However, both transactional profit methods and formulary apportionment involve the use of allocation keys and formulas rather than actual marketplace evidence of third party dealings. It is not in the best interest of the arm's length principle for it to appear aligned with, or to be moving in the direction of, formulary apportionment; narrowing the proposed use of the OECD's profit split will help in this regard.

In conclusion, the Group suggests that the *Proposed Revision* be amended to restrict the use of the OECD's profit split to those circumstances in which the related parties, whether two or more, each contribute non-routine valuable intangibles and where there is no reasonably reliable marketplace evidence available that will satisfy the arm's length standard. In other words, the Group recommends that the OECD's profit split not be utilized, as the *Proposed Revision* would seem to allow, solely because of one or more of the following:

- there is a perception that the operations of the unrelated parties are "highly integrated;"
- the unrelated parties contribute unique and valuable "assets" other than intangible assets;
- one related party to the transaction performs complex functions or makes a significant unique contribution;

[32] Paragraph 1.18 of the *Proposed Revision*.

- a "one-sided" transfer pricing method is perceived not to be "appropriate."[33]

3. Greater Emphasis on Types of Comparables Rather Than on Types of Methods. At various points, the *Proposed Revision* acknowledges the significance of "comparables" in a successful and reliable transfer pricing analysis. For example, the *Proposed Revision* states:

> As part of the process of selecting the most appropriate transfer pricing method … and applying it, the comparability analysis always aims at finding the most reliable comparables.[34]

Other comments in the *Proposed Revision,* however, understate the critical role that comparables play. Examples of understatement are found in Chapter III (Comparability Analysis). For instance, the *Proposed Revision's* discussion of the typical process for determining transfer pricing lists as step 6 the selection of the most appropriate transfer pricing method and, as step 7, the identification of potential comparables.[35] Along the same lines, the *Proposed Revision* mentions a taxpayer selecting "a resale price method" and "then again try to identify comparables…."[36] Similarly, at other points the *Proposed Revision* suggests that the choice of the method influences the evaluation of the comparables.[37]

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[33] Paragraph 2.63 of the *Proposed Revision*.
[34] Paragraph 3.2 of the *Proposed Revision.*
[35] Paragraph 3.5 of the *Proposed Revision*. The Group recognizes that this process is not intended to be linear or exclusive, but the *Proposed Revision* characterizes it as typical.
[36] Paragraph 3.6 of the *Proposed Revision.*
[37] Paragraph 1.38 of the *Proposed Revision.*

The Group suggests, with all due respect, that in its experience it is the availability and selection of particular types of comparables, and the amount and quality of the data available with respect to the comparables for the tested party or transactions, that generally drives the choice of “method” and not the other way around.

To elaborate, after analyzing the taxpayer’s own circumstances including its transactions and functions, the typical and appropriate next step is to search for potential comparables. Sometimes it is fairly obvious, or it becomes apparent quickly, that certain types of potential comparables are unavailable (*e.g.*, comparables that may lead to what the *Guidelines* call a “CUP”) while other types of potential comparables are readily available (*e.g.*, groups of publicly traded companies for which overall financial results are available and that the *Guidelines* refer to in the context of the transactional net margin method).

Once the process of selecting the potentially most reliable comparables has led to results, then consideration is appropriately directed to whether, given the likely comparables, it is more reliable to look at one financial measure rather than another (*e.g.*, price vs. gross margin vs. operating margin vs. return on assets). Thereafter, and as a separate matter, the taxpayer may use yet another financial measure internally to implement or achieve results consistent with the financial results of the comparables.

The Group urges the OECD to revise the *Proposed Revision* to state clearly that selecting the most reliable comparables generally comes before choosing a method. In fact, the choice of comparables heavily influences if not determines the selection of a "method." Such a change is advisable not only because it reflects the reality of what occurs in practice in sound transfer pricing analyses, but because it serves as a reminder that the hallmark of the arm's length standard is a reliable match-up of the taxpayer's related party transactions with what occurs in the marketplace between unrelated parties (*i.e.*, the comparables). Emphasizing comparables also simplifies the explanation of how to achieve the objective of finding the most reliable marketplace evidence with which to satisfy the arm's length principle. The *Proposed Revision's* over-emphasis of methods reflects old terms and old views that have changed and gets in the way of providing the clearest possible guidance.

The Group recommends that the OECD make other related changes, discussed next, to add clarity to its guidance about comparables and their use by taxpayers and tax administrations.

4. <u>The OECD *Guidelines* Should Highlight That There Basically Are Only Three Types of Comparables/Benchmarks</u>. In practice, there are only three categories of marketplace comparables and other benchmarks under the arm's length standard, as the *Guidelines* interpret it, and the Group urges the OECD to revise the *Guidelines* to make this basic fact clear.

The first category consists of one or more specific marketplace agreements (typically contracts) between unrelated parties. The agreement or contract, which may be internal or external to the taxpayer, could be for the provision of a service, the license of intellectual property, the contractual sharing of R&D costs, the manufacture of a product, or the purchase or sale of property, among other commercial transactions. Frequently, but not always, one has access to the terms and conditions of the agreement or contract as well as, at least in the case of internal comparables, to the financial consequences of the agreement or contract to one party or the other.[38]

The second category of comparables consists of the overall activities of companies that engage in businesses of a particular type, such as providing services, licensing intellectual property, manufacturing property, purchasing and reselling property, etc. Typically such companies are publicly traded and as a consequence disclose their financial results at a high level;[39] they usually do not disclose the details of the terms and conditions of their underlying arrangements with their third-party suppliers or customers nor release copies of agreements or contracts that they may have with them.

The third category consists of benchmarks based on economic concepts or theories, such as the concept of sharing profits based on the relative intangible development costs of the affiliates or other theory-based allocation keys or determinations that use a taxpayer's internal data (referred to above as the "OECD's profit split"). While worldwide formulary apportionment is a theory-based approach to transfer pricing, the *Proposed Revision* rejects formulary apportionment as being inconsistent with the arm's length standard.

[38] A third party agreement or contract that is with the taxpayer ("internal comparable") typically provides more financial and other data than if the contract or agreement is between two other parties ("external comparable").

[39] Commercial databases are commonly used to retrieve data for such comparables. See paragraph 3.32 of the *Proposed Revision.*

To summarize, in practice the application of the arm's length standard as interpreted by the *Guidelines* and the *Proposed Revision* really entails the use of one, or possibly of more than one, of only three types of comparables or benchmarks. The first two categories are based directly on what has occurred in the marketplace between unrelated parties and in this sense are certainly consistent with traditional views of the arm's length standard. On the other hand, the third category relies in part or entirely on economic theory rather than on marketplace evidence. A Category 1 comparable has a greater potential for reliability than does a comparable in Category 2 and comparables in both of those categories have greater potential for reliability than does the theory-based benchmark in Category 3.

Thus, like Gaul, transfer pricing can meaningfully be divided into *partes tres.* While these three parts or categories may be apparent to some governments and taxpayers, particularly those with considerable experience, that is not always the case.

In the first instance, not all readers and users of the OECD *Guidelines* are experienced and sophisticated in transfer pricing. The OECD *Guidelines* play the important role of informing many governments and taxpayers, some of whom are relatively new to transfer pricing for income tax purposes. Making clear the *partes tres* delineation in transfer pricing will serve the community of tax authorities and the community of international business well. It will be beneficial in part because, as is explained further below, it will help address some of the confusion that can easily arise when using the traditional terminology of the *Guidelines* about "methods," uses of data bases, "relative reliability," and how to choose the most reliable comparables and most appropriate method.

As is explained in the next section of this letter, the terminology and jargon that has developed over the years is not well suited for the future as the OECD moves away from a somewhat rigid hierarchical system of choices and departs from old beliefs about the use of profits measures, to a process in which "judgment" plays a much larger role and the "playing field" is level, even though not all the players (*i.e.*, the three types of comparables and benchmarks) are created equal in terms of their potential reliability. The shift from "hierarchy" to more "judgment" would benefit from new ways of addressing issues. Such a shift could help avoid heading in the direction of result-driven choices, confusion, or even transfer pricing "anarchy."

5. The OECD *Guidelines* Can Improve Their Guidance by Deemphasizing the Use of Traditional Phrases and Adopting Other References. A particularly important objective of the *Proposed Revision* is, as just mentioned, to remove a somewhat rigid hierarchy of "methods" for transfer pricing. Moving away from a hierarchy and towards exercising more judgment puts additional pressure on the OECD to clearly articulate its guidance lest there be confusion. Confusion can easily arise today given the terms and phrases currently in the *Guidelines*. For example, among the OECD *Guidelines* descriptors or labels for "methods" today are the following:

Comparable uncontrolled price method

Resale price method

Cost plus method

Traditional transaction methods

Transactional profit split method

Transactional net margin method

Transactional profit methods

Some of these phrases do not actually mean what their words would normally imply. For example, “transactional net margin method” encompasses methods that typically are not “transactional;” *i.e.*, they do not rely on prices or mark-ups or other evidence from individual transactions of third parties. Instead, the methods within the scope of the “transactional net margin method,” and for that matter transactional profit methods and the residual version of transactional profit split, almost always depend upon overall financial results from the aggregate business activities of a third party company or companies with their various suppliers and customers.[40] Nor do the *Guidelines’* transactional “net margin” methods necessarily use net margins; for example they commonly use returns on assets or mark-ups on costs that are not normally thought of as net margins.

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[40] Paragraph 3.36 of the *Proposed Revision* describes the use of “non-transactional third party data.” Although the paragraph does not refer to any specific OECD pricing method its comments appear directed at the “transactional net margin method.”

Thus, these traditional phrases are easy to misunderstand or misuse. For instance, there are references in the *Proposed Revision* to transactional profit methods where it is likely that the drafters were really thinking only of the transactional profit split method and not the transactional net margin method. However, the latter two are both within the scope of "transactional profit methods".

Several of the current phrases do not do justice to the significance of the potential reliability of the different types of comparables and benchmarks mentioned above while overstating the importance of financial measures. For example, it appears that the *Guidelines'* "transactional profit methods" can be based on a third party agreement or contract ("Category 1") using, for example, a return on assets, or a split of profits; the overall financial results of the overall business activities of companies that are usually publicly traded ("Category 2") using, for instance, a cost-based profit or margin, a net margin, or a return on assets; and a theory-based split of profits ("Category 3").

Thus, the phrase "transactional profit methods" encompasses far too much in terms of qualitatively different comparables and benchmarks (*i.e.*, they are of inherently different levels of reliability) and "methods" to give clear guidance in a pricing system that will require taxpayers and tax authorities to exercise judgment in making choices that are intended to achieve the highest possible reliability.

At the same time, the structure implied by the traditional phrases is too confining in certain respects relevant to reliability. To illustrate, consider that a Category 1 comparable – a contract between unrelated parties – can in principle use various financial measures, including profit-based measures, and still have greater potential reliability than a reliable Category 2 set of comparables. However, the phrase "traditional transaction methods," as used today in the *Guidelines* encompasses only a few of the following financial measures (the ones with check marks) that are found in third party contracts.

Financial Measures

√ a. Price, fee, royalty and other similar amounts

√ b. Gross profit or margin

√ c. Cost-based profit (mark-up)

d. Cost-based margin

√ e. Gross profit/operating costs

f. Operating (net) profit or margin

g. Asset-based operating profit

h. Split of profits

i. Sharing of income

j. Sharing of costs (*e.g.,* R&D cost sharing)

k. Other

Thus, the *Guidelines'* "traditional transaction methods" phrase covers only financial measures a-c and e. The phrase excludes profit-based measures such as f, g and h. Why should that be the case? In part, the exclusion may be attributable to the much smaller body of knowledge about transfer pricing and the use of third party contracts, as well as a prejudice against using profit methods, existing when the *Guidelines* and their predecessors were originally adopted. However, times have changed and the commercial use of third party contracts has proliferated in a world of increasing outsourcing, joint ventures, etc. Coupled with this growth of third party arrangements is an increased diversity of financial measures and types of compensation that these contracts provide. Finally, traditional prejudices against the use of transfer pricing methods that rely on profits have changed.

Therefore, rather than focus on “traditional transaction methods,” which is too narrowly defined to cover some potentially reliable uses of Category 1 comparables, future *Guidelines* should emphasize the significance of finding and using a Category 1 comparable (whatever the financial measure) as contrasted with using a Category 2 set of comparables or a Category 3 theoretical benchmark. This change in emphasis is more likely to advance the process of achieving reliability than continuing to focus initially or otherwise on whether the financial measure is of the “traditional” type or of another type (*e.g.*, profit based).

Even the old phrases “resale price method” and “cost plus method,” both of which are “traditional transaction methods” intended to be used only with respect to what this letter calls Category 1 comparables, are misunderstood and misused. It is not unusual in practice for those two phrases to be used with what this letter calls Category 2 comparables. The *Guidelines* appear to intend to characterize such Category 2 situations as applying the transactional net margin method. However, the *Guidelines* acknowledge that the transactional net margin method “operates in a manner similar to the cost plus and resale price methods."[41] Thus, these *Guidelines'* labels may overlap in the minds of some. In any case, the significance of these different old terms in the *Guidelines* is frequently lost.

In the experience of the Group, it is infrequent for there to be more than one reliable Category 1 comparable available in a given circumstance, and rarer yet for such comparables to use different financial measures. Consequently, it would be uncommon to have a debate in a taxpayer's particular circumstances about which of the financial measures used by different Category 1 comparables, such as a cost-based profit, a return on assets, or a split of profits, is more reliable than the others. If it is made clear that a reasonably reliable Category 1 comparable is generally going to be more reliable than a Category 2 comparable, then the process will be appropriately streamlined.

Typically there are no reliable Category 1 comparables available and the transfer pricing analysis considers whether there are reliable Category 2 comparables. When using Category 2 comparables there can be questions about whether one financial measure is more reliable than another. It is at this point that the discussions of the *Proposed Revision* about the reliability of cost-based margins, gross profits or margins, and asset-based operating profit, etc. become relevant.

Today's *Guidelines* recognize, within the scope of "transactional net margin method," financial measures f and g as being available and potentially reliable when using results of the overall business activities of publicly-traded companies (Category 2) as

[41] Paragraph 2.100 of the *Proposed Revision*.

marketplace benchmarks. The *Guidelines* do not clearly acknowledge the availability and potential reliability of financial measures d, e and k based on such comparables, but it is possible that they are included. The “transactional net margin method” is too narrow and confining in this regard with respect to Category 2 comparables, in the view of the Group.

At the same time, “transactional net margin method” may encompass Category 1 comparables using financial measures d, e, f and g. As mentioned above, it is highly unlikely in a given case that there will be both a Category 1 comparable using, for example, an operating profit (f) and another one using a gross profit (b). It is more important to recognize that it is highly likely that any reliable Category 1 comparable, using any reliable financial measure, will be more reliable than any reliable Category 2 comparable using any reliable financial measure. The *Guidelines* should find a way to make that apparent. Again, the *Guidelines’* terminology focused on profits was developed at a prior time when all profits methods were stigmatized and there was relatively little experience with today’s approaches to transfer pricing; that is no longer the case.

In brief, the manner in which the *Guidelines* address financial measures and comparables under “traditional transaction methods” and the “transactional net margin method” is indicated in the following two tables.

Table 1
Traditional Transaction Methods

Category 1	Category 2
√ a. Price, fee, royalty and other similar amounts √ b. Gross profit or margin √ c. Cost-based profit (mark-up) d. Cost-based margin √ e. Gross profit/operating costs f. Operating (net) profit or margin g. Asset-based operating profit h. Split of profits i. Sharing of income j. Sharing of costs (*e.g.,* R&D cost sharing) k. Other	a. Price, fee, royalty and other similar amounts b. Gross profit or margin c. Cost-based profit (mark-up) d. Cost-based margin e. Gross profit/operating costs f. Operating (net) profit margin g. Asset-based operating profit h. Split of profits i. Sharing of income j. Sharing of costs (*e.g.,* R&D cost sharing) k. Other

Table 2
Transactional Net Margin Method

Category 1	Category 2
a. Price, fee, royal and other similar amounts b. Gross profit or margin c. Cost-based profit (mark-up) √ d. Cost-based margin e. Gross profit/operating costs f. Operating (net) profit or margin √ g. Asset-based operating profit √ h. Split of profits √ i. Sharing of income j. Sharing of costs (*e.g.,* R&D cost sharing) k. Other	a. Price, fee, royalty and other similar amounts b. Gross profit or margin c. Cost-based profit (mark-up) ? d. Cost-based margin ? e. Gross profit/operating costs √ f. Operating (net) profit or margin √ g. Asset-based operating profit h. Split of profits i. Sharing of income j. Sharing of costs (*e.g.,* R&D cost sharing) ? k. Other

The *Guidelines'* "transactional profit methods" encompasses all of the items checked off in Table 2, plus theory-based splits of profits.

In conclusion on this point, the Group suggests that future *Guidelines* decrease their reliance on traditional phrases. This could be accomplished in different ways. Whatever means are chosen, the key points are:

- to regularly remind the reader whether a discussion in the *Guidelines* is with respect to a Category 1 or Category 2 marketplace comparable or to a Category 3 (theory-based) benchmark;
- to make clear that Category 1 comparables can reliably be used with financial measures a-k and that Category 2 comparables can reliably be used with financial measures b-g; and
- that reliable Category 1 comparables (whatever the financial measure) are likely more reliable than a Category 2 comparable and both are more reliable than a Category 3 benchmark.

This last suggestion above concerns "relative reliability," which the next section discusses further.

6. The *Guidelines* Should Emphasize and Illustrate the Significance of "Relative" Reliability. In moving away from a relatively rigid hierarchy in which all profit methods have a last resort stigma and "CUP" is automatically of the highest reliability, and towards a "most appropriate method" approach that is based on facts and

circumstances, the OECD has undertaken a great challenge. Part of the challenge is to inform tax authorities and taxpayers of the strengths and weaknesses of (a) different types of comparables or benchmarks and (b) different types of financial measures that can be applied to them.

A related step in this regard, which the Group believes requires additional emphasis in the *Guidelines*, involves illustrating the concept of <u>relative</u> reliability. The *Proposed Revision* leaves it to the good judgment and experience of taxpayers and tax authorities to choose what is the most appropriate method given the facts and circumstances of the taxpayer and including, of course, what reliable comparables or benchmarks are available and what financial measures can be reliably used with them.

It would be useful in this regard if the *Guidelines* contained a separate section consisting of a series of brief examples that illustrate that in certain factual circumstances one type of comparable or benchmark is relatively more reliable than another and why, given the choice of comparable or benchmark, one type of financial measure is relatively more reliable and why.

A set of *Guidelines* that is successful in terms of providing clear guidance on how to make such choices will reduce uncertainty and controversy; ideally it will consistently lead different persons – whether taxpayers or tax authorities – to choose at least the same type of reliable comparable or benchmark if not also the same financial measure for that type of comparable or benchmark given the particular taxpayer and its circumstances. The Group understands that, no matter how clearly the *Guidelines* are written, reaching such consensus consistently is an ideal, not a likely reality. Nonetheless, without changes along the lines suggested here or others of a similar nature, the *Proposed Revision* and future *Guidelines* will likely fall short of what could otherwise be accomplished in this regard.

7. The *Guidelines* Should Further Illustrate How to Make Adjustments to the Comparables. Part of the process of exercising good judgment in selecting the most reliable comparables or other benchmarks involves recognizing the need for and the advisability of making adjustments to them to more reliably reflect the circumstances of the taxpayer in question. The *Proposed Revision* acknowledges that there can be differences between comparables or benchmarks and the taxpayer and in new paragraph helpfully identifies some of those differences.[42] The *Proposed Revision* also shows, by way of example, how to calculate a working capital adjustment.[43]

The Group recommends that there be more illustrations in the *Guidelines* of how to make adjustments for differences (*e.g.*, volume or operational scale, risks, or geographic market). For instance, how might a taxpayer or tax authority reliably determine the increase in expected return when there is an assumption of increased risk?[44]

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[42] Paragraphs 3.47-3.51 of the *Proposed Revision*.
[43] Annex III to Chapter II, Part III in the *Proposed Revision.*
[44] Paragraph 1.45 of the *Proposed Revision* maintains that such an increase is appropriate but does not explain how to quantify the increase. The topic of how to determine whether a taxpayer has certain risks is an important one. The Group does not concur with the *Proposed Revision's* carryover of the "control" concept from old paragraph 1.27 to new paragraph 1.49. Alternative approaches were suggested at the June 2009 OECD Consultation on the Transfer Pricing Aspects of Business Restructurings.

By way of examples the *Guidelines* can also illustrate whether, even without adjustments for material and lesser differences, comparables can be reliable or reasonably reliable and more or less reliable than another category of comparables or benchmarks that might be available. To provide an illustration, if there is an otherwise reliable Category 1 comparable but its transaction occurs in Europe rather than in North America (where the tested party is), should the Category 1 comparable be abandoned in favor of Category 2 comparables that do not have geographical market issues but that otherwise are subject to the general shortcomings and limitations of relying on the overall business activities and results of publicly-traded companies (Category 2)? The Group believes that the answer to this question should be "no" in many cases. In any event, an example can illustrate how this relative reliability issue should be analyzed.

The relative reliability of different categories of comparables or benchmarks or of different potential comparables within a category, when compared to each other, should not be confused with how closely the comparables or benchmarks must match the facts of the tested party (*i.e.*, the taxpayer). The *Guidelines* should illustrate, through examples, that comparables or benchmarks may not perfectly mirror the tested party or its transactions and that the lack of perfect comparability is not a justification for moving from a reasonably reliable Category 1 comparable to a reasonably reliable Category 2 set of comparables or from the latter to a Category 3 benchmark (theory). In this way the *Guidelines* can illustrate a "natural hierarchy" in selecting comparables and methods. Unfortunately, the *Proposed Revision* does not achieve this level of guidance.[45]

8. Cautionary Remarks About Ranges and Statistics. The *Proposed Revision* accurately notes that having a large number of "would be" comparables is not a substitute for addressing important flaws with such comparables. It also notes that a group of "would be" comparables may have defects that cannot be identified and/or quantified and thus are not addressed through adjustments.[46] The *Proposed Revision* also suggests that if a range of results is large enough, then the use of statistical tools (*e.g.*, measures of central tendencies) might help enhance reliability.

The Group would like to point out that in some jurisdictions measures of central tendency, such as an interquartile range, can be overused and do not always appear to enhance reliability. For example, how does the interquartile range enhance the reliability of a group of companies (Category 2) each of which differs significantly from the taxpayer or the tested transactions? How does the interquartile range correct for the material operational differences between the benchmarks and the tested party or transactions?

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[45] Paragraph 2.2 states that CUP is preferred in circumstances where both it and "another transfer pricing method" can be applied in an "equally reliable manner." While the Group appreciates the preference for CUP it is hard to imagine a reliable CUP being equaled in reliability by a transactional profit method or even other traditional methods. Perhaps an example could illustrate and explain further what was intended by this statement in the *Proposed Revision*.

[46] Paragraph 3.56 of the *Proposed Revision*.

To be sure, the interquartile range narrows the range of the financial results of a group of allegedly reliable comparables by eliminating the comparables that are “outliers” in terms of their financial results. However, do outlying financial results necessarily have anything to do with the qualitative, substantive or operational differences at issue? As the *Proposed Revision* states, “it is the facts and circumstances surrounding the company in question that should determine its status as a comparable, not its financial result.”[47] Using statistical measures such as the interquartile range narrows the range of financial results, leaving out loss companies and excluding companies with relatively high profits. However, those losses, or high profits, may in fact be from the companies that are most comparable to the tested party or transactions.

In brief, the Group is pleased that the OECD endorses the appropriate use of statistical measures, including the interquartile range. However, the *Guidelines* should emphasize through examples that statistical measures do not necessarily enhance the reliability of the results and should not be a substitute for selecting the right type of comparable or making adjustments for material differences where possible.

Conclusion

As an overall matter, the Group endorses the directions in which the *Proposed Revision* would move the *Guidelines*, particularly towards acceptance of appropriate use of what the *Guidelines* unfortunately call the transactional net margin method and away from a relatively rigid hierarchy of methods. Substituting more judgment for a relatively rigid

[47] Paragraphs 3.63 and 3.64 of the *Proposed Revision*.

hierarchy will not work well, however, if the *Guidelines* are unclear or inadvertently give or allow the impression that "all methods are created equal," that "all types of comparables are created equal" or that "methods" rather than "comparables" come first in sound transfer pricing analyses.

The use of the OECD's profit split should be narrowed carefully. The number of new paragraphs concerning the OECD's profit split is striking, even without taking into account Annex I, which is entirely dedicated to that method. The impression given is that the OECD's profit split is moving from "last resort" towards "first place."

In contrast, there is no new guidance on key matters that arise frequently such as how to make adjustments in Category 1 or 2 situations for differences in risk or geographical markets or how to assess relative reliability between different comparables of the same or different types (referred to here as categories). Why, in this regard, "must" it be "assumed" that missing information on "key contract terms" about a (Category 1) comparable necessarily precludes its use because this information is critical to assessing its reliability?[48] It is possible that this comparable is still more reliable than any other comparable or benchmark.

More attention should be given in a separate section with examples to the relative potential reliability of the two categories of marketplace comparables and the Category 3 benchmarks mentioned above, and why they are not created equal (regardless of

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[48] Paragraph 1.53 of the *Proposed Revision.* This paragraph implies that the comparable cannot be used although it does not state this exactly.

financial measure). Additional and clear guidance on these matters will reduce the circumstances in which taxpayers and tax authorities can too readily justify their selections from many potential comparables, theory-based benchmarks and financial measures. The better the guidance in this regard from the OECD, the less often there will be controversy, confusion or uncertainty. With enhanced guidance, taxpayers and tax authorities will, more frequently, arrive at similar comparables or benchmarks, financial measures and results. Many of the suggestions set forth above are intended, in particular, to help narrow the potential range of differences between taxpayers and tax authorities in a transfer pricing system that leaves more decisions to judgment rather than to prescriptive rules.

As they stand now, the amendments to the *Guidelines* offered by the *Proposed Revision* appear unlikely to substantially narrow key differences in choices between taxpayers and tax authorities. The Group is especially concerned about how the *Proposed Revision* might be interpreted by those who are results oriented or more interested in tax revenue than reliability, particularly through over-use of profit splits. Thus, giving additional guidance by way of illustrations and examples and reducing reliance on old *Guidelines’* phrases that do not adequately reflect a new “most appropriate” approach to transfer pricing would be helpful. It may be advisable to add a new succinct overview of key principles and, as indicated to put some of the examples and illustrations, particularly of relative reliability, in separate sections.

In conclusion, the Group appreciates the progress that Working Party No. 6 has made in addressing this difficult subject. The Group will be pleased to elaborate on its comments and to assist the OECD in other ways. Please feel free to contact the undersigned.

Sincerely,

Steven Hannes

Steven P. Hannes