

***Comments to the proposed revision of Chapters I-III
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Introduction

Since the release of the 1995 OECD Transfer Pricing Guidelines (“TPG”), TP has grown exponentially as a perceived revenue source, and thus as a focus area, for tax authorities. It has expanded correspondingly in terms of financial and operational impact for MNEs and, finally, triggered a significant increase in public awareness of the phenomenon.

The current proposed revision reflects parts of this. More precisely, it expresses the experience of tax authorities in dealing more actively with the subject of TP in general, in applying the 1995 TPG and in using TNMM more in particular. As a result of these practical experiences, the proposed revision redefines the hierarchy of methods by abolishing the “last resort” status that profit-based methods acquired in the 1995 TPG, and offers guidance on comparability analysis and on the (technical) application of methods, with added examples of how to deal with TNMM.

The past 15 years, and the last 5 years more in particular, have however shown more than a marked growth in popularity of TNMM.

It has become clear, by way of increased levels of controversy and settlements in and out of courts worldwide, that improved consistency in dealing with TNMM is as such not sufficient for developing answers to the real challenges that TP presents to MNEs. These challenges are often related to the existence of intangibles. As soon as intangibles play a role, the TPG seem to hesitate to give appropriate guidance. In those more challenging situations, as evidenced in the BRDD as well as in a multitude of court cases in different countries, there is a fundamental uncertainty about applying the most basic starting point in TP, i.e., the arm's length principle (“ALP”).

The current approach of the TPG directs its focus to the “tested *party*” and tends to ignore the relations between the *parties* involved in the transaction(s) under scrutiny. As a consequence, issues like bargaining power of the parties – indispensable in analyzing the arm's length character of pricing – remain in the dark.

We think that part of this uncertainty may well be a direct result of how Chapter I defines and explains the ALP. We will give some suggestions as to how the principle can be applied more consistently.

In respect of Chapter II we suggest that, when dealing with TP methods, the focus is broadened in order to give more attention to the ex-ante aspects of dealing with TP, i.e., how MNEs effectively can *set* prices before transactions take place. Pricing of transactions is after all not a subject that MNEs can choose to enter into or not, but they

have to, even if their intercompany transactions simply lack the direct market imperatives that transactions between independent parties are subject to.

By taking the ex-ante aspects of TP into account, the TPG would relieve its virtually exclusive focus from ex-post aspects (testing prices and/or outcomes) and set the stage for a more balanced attention for the TP challenges that MNEs have to deal with in practice.

The suggestions in respect of Chapters I and II will inevitably have consequences for the process of dealing with comparability as described in Chapter III.

Having emphasized the challenge for MNEs of how to set prices, it is useful to say a few words about the public perception of TP. When people that have little experience with the subject of TP try to give a definition thereof, the first reference is almost invariably "abuse". In the public perception (as evidenced by many press publications as well as statements from non-tax authorities), TP is something that can not only be, but is indeed exclusively, used by MNEs to avoid, or even evade, taxes. The TPG (par. 1.2: "Tax administrations should not automatically assume...") do little, if anything, to adjust that perception.

We are of the opinion that the revised version of the TPG represents a unique opportunity to promote a more balanced public perception of the issue. This could be achieved by, on the one hand, confirming the challenge that TP presents to MNEs and, on the other, emphasizing the corporate responsibilities that MNEs carry in this respect. Such would bring the TPG also in sync with the OECD Guidelines for MNEs, which form part of the OECD Declaration on International Investment and Multinational Enterprises of June 27th, 2000. By doing this, the TPG might well give the most effective contribution possible to achieving a balanced and responsible practice of dealing with TP globally.

Observations

1. The Statement of the ALP

Article 9, paragraph 1 of the OECD Model Tax Convention ("MTC") provides:

"[When] conditions are made or imposed between ... two [associated] enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly."

The TPG, when elaborating the concept and clarifying the application in practice, immediately depart from this fundamental starting point. By giving free, inexact and

varying, interpretations of the wording of the principle, the focus becomes incorrectly restricted. An illustration.

Par 1.2 gives a free interpretation: "..., the conditions of their commercial and financial relations (*e.g.* the price of goods transferred or services provided and the conditions of the transfer or provision)...." Are conditions of the relations indeed the same as conditions for transactions?

In a next step (par 1.6), the "commercial or financial relations" are summarized as "circumstances". After combining "comparable transactions and comparable circumstances", the focus is subsequently narrowed by the added clarification "*i.e.* in "comparable uncontrolled transactions"". It is stated that the "attention is focused on the nature of the dealings between ... members (of an MNE group) and on whether the conditions thereof differ from the conditions that would be obtained in comparable uncontrolled transactions". Par 1.6 continues: "Such an analysis of the controlled and uncontrolled transactions, which is referred to as a "comparability analysis", is at the heart of the application of the ALP."

Although this is most likely not the intention, this is nevertheless the explanation for the fact that in the rest of the TPG, focus is virtually exclusively placed on "transactions" and that attention for the "commercial and financial relations", as the necessary context for the transactions, is no longer part of the basic process of dealing with the ALP.

Transactions are the materialization of the commercial or financial relations between enterprises. Commercial and financial relationships, both between independent and between associated enterprises, can take many different shapes. They can be incidental, involving one or a limited number of transactions, or can be of long duration, with clear intentions of cooperation. Conditions of transactions will not be comparable categorically with those of similar transactions, but only with those applied for transactions in the context of relationships of a similar type. Furthermore, relationships constitute a different context depending on their capacity investment impact. If one of the parties has invested heavily, *e.g.*, by building a manufacturing plant and hiring a large number of employees, and that investment turns out to be obsolete earlier than foreseen, then the impact on the price (*i.e.*, terms and conditions) of transactions between the parties will be different depending on their type of relationship. Was the relation purely transactional, then it will be the risk of the investing party; is the context a long-term, cooperative relationship, then parties will find a way to share the consequences of the unforeseen event.

We propose to improve consistency in the application of the arm's length principle by introducing a slight adjustment in the wording of the statement of the principle. The following might be considered.

Starting point is the first part of the definition:

"[When] conditions are made or imposed between ... two [associated] enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, etc."

The first word is “*conditions*”. Usually, this is what is meant by “transfer prices”. They are explained (par. 1.7) to be “including prices, but not only prices”. We propose to clarify that word as meaning “*terms and conditions, applied to transactions*”. This systematically broadens the scope to include issues like delivery terms, size of transactions, choice to add components or not, choice to combine it with repair service contracts etc. All these elements play a role in direct connection with the “price” of a transaction.

We think that the suggested precision of the statement of the ALP will be the first step towards a broader and more effective application of the principle. The next step is to give it a place in the Guidance for applying the ALP.

2. The Guidance for applying the ALP: the *five factors*

The effects of the free interpretation of the principle become visible in par. 1.33 and following, describing the significance of the comparability analysis. It states that in order for comparisons of transactional conditions to be useful, the “economically relevant characteristics of the situations being compared, must be sufficiently comparable.” Here again, different issues are mixed and a new term, “situations”, is introduced.

What is intended to be stated, and what we now, after the clarification in the above, can word more coherently, is that we wish to establish (whether ex-post or ex-ante) the arm’s length character of (terms and) conditions applied to transactions, taking place in the context of a certain given relationship, and taking into account possible differences in the economic circumstances. Comparability of the (terms and) conditions is therefore depending on

1. The transaction(s);
 2. The functional involvement of the parties to the transactions;
 3. The commercial and financial relations between those parties; and
 4. The economic circumstances;
- all of this to be documented and (to the extent possible) confirmed by contracts.

The “factors determining comparability” are described in par. 1.38-1.62, the so-called *five factors*. The question is where the “new” dimension, the relationship, can find a place.

The relationship plays no role in the first factor, the characteristics of property or services. They define the transaction in a narrow sense.

Relationships might very well receive more visibility in the functional analysis, the second factor, but there is a reason that this usually does not appear. The functional analysis in the “one-sided” attention for the “tested party” in TNMM-applications tends to look at entities in a stand-alone assumption. Testing-only approaches using benchmarks incite the use of oversimplified abstractions of entity (“routine”) activities. Not because these reflect reality, but because they facilitate comparables searches. Essential is however to understand how parties to a commercial or financial relationship

interact to create economic value together, and how each of them benefits. Their contribution to that value creation is decisive for their bargaining power, and consequently the terms and conditions, and outcome, of transactions. In order to understand that, describing functions, assets and risks is one thing, but understanding how the respective roles and responsibilities are allocated to the parties is another.

In the contractual terms, the third factor, it will come up as a confirmation (to the extent possible), but the real place for an analysis of the relational context should be found in either the fourth or the fifth factor.

The fourth factor is the “economic circumstances”, and although the definitional part of Chapter I assimilates the relationship with “circumstances”, see earlier, the comments in par 1.54-1.57 sharpen the definition of circumstances to *external* issues influencing the market.

Therewith it is the fifth factor, described as “business strategies”, that should be the appropriate place for giving attention to the economic and financial relationship of the parties. This is indeed the factor that should absorb the relational context. Strategies are not an isolated or incidental phenomenon, but the defining strategies and the roles and responsibilities of the transacting entities, takes place in the context of their relationship. We therefore suggest to reword the fifth factor into “Strategic context”, and extend the explanations accordingly to identify the relationships.

The five factors make their re-appearance in Chapter III, which introduces “a typical process” for performing a comparability analysis. Describing such process is an effort that is potentially helpful and should be welcomed.

A process can be defined as a “coherent series of steps, converting an input into an output”. It is not just a series of steps, but the coherence is key, and in the context of a process the sequence of the five factors would more logically rank the strategic context as the third, and contracts as the fifth factor.

Taking the suggestions placed above to heart would also imply a reconsideration of the process description (whether typical or not) in Chapter III. In the current description, it is in particular step 3 that reveals the focus on testing, and the assumption that TNMM, with its search process in the next steps, is the method of choice.

That means that the “output” of this process is a comparability analysis for testing purposes only. It is worth noting that comparability analyses for purposes of designing transfer pricing systems, enabling MNEs to manage internal pricing involve considerably more than what is shown in the “typical process”.

3. The “cases in which the ALP is difficult and complicated to apply” and the scope of the TPG

Par 1.9 states that the ALP “has been (...) found to work effectively in the vast majority of cases.” The nuance follows immediately after this reassuring observation, when the

paragraph continues to say that "there are some significant cases in which the ALP is difficult and complicated to apply..."

The text adds an example of "MNE groups dealing in the integrated production of highly specialised goods, in unique intangibles and/or in the provision of specialised services". This invites a few questions.

Aren't "integrated" operating models a key characteristic of the way most MNEs operate? Aren't all MNEs trying to develop "unique intangibles"?

These questions indicate indeed exactly the main challenges in TP, which can only be met by identifying the "commercial and financial relations" between parties inside an MNE, in order to be able to come to relevant conclusions about the bargaining power of independent parties in such "similar circumstances".

It is obvious (par. 1.10) that this is not necessarily simple, but that can not be a reason to categorically give up on the requirement of judging the ALP in the appropriate "circumstances", i.e., by giving due attention to identifying the relevant commercial and financial relations in which the group entities concerned carry out the transactions under scrutiny, as well as to the economic circumstances. The relational context has an impact on the terms and conditions at which independent parties in the market would agree to enter into similar transactions, and under similar circumstances.

Giving appropriate attention to the full set of relevant aspects in interpreting the ALP will also diminish confusion in discussions about more complex situations such as business restructurings. Proof of the need of careful analysis of the relational context can further be found in a series of highly relevant recent court cases, with Dixons (UK) and GE Capital Canada as significant examples.

The TPG have the ambition to issue guidance both to tax authorities and to MNEs. In reality however, it concentrates on *testing* as an exercise, which is particularly interesting in an operational sense for tax administrations, but only valuable to a limited extent for MNEs. It is worth noting that a substantial part of all business-to-business transactions in the global economy, and an even larger part of cross-border transactions (estimates mention a proportion of between 50% and 75%), take place between related parties.

For most of these transactions there is simply no market price available, so it is the responsibility of MNEs to set these prices themselves. This is not a choice, it is a must. The choice is in how companies deal with this. Is it by presuming abuse, and emphasizing scrutiny and sanctions? Or can it be done by emphasizing the fact that a balanced approach to the issue is part of the corporate responsibilities? We think that the last approach deserves more attention, and it would align the TPG with the OECD Guidelines of June 27th, 2000, and with its par. 61 and 62 more in particular. The TPG should encourage MNEs to assume this responsibility, and give more guidance in successfully taking up the challenges in this respect. It also gives the TPG the opportunity to approach the subject of transfer pricing in all objectivity and take distance from biased public perceptions.

4. Conclusion: one-sided methods or one-sided analyses?

We recommend reconsideration of the terminology used, as there is no pricing method “one-sided” if applied to *set* prices. It is the analytical approach that can be one-sided, not the pricing method as such. The use of the term is rather the illustration of the dominant pre-occupation of the TPG with *testing* as the focus, which happens to be primarily relevant for tax administrations.

TNMM is a highly relevant method as a testing approach and gives a meaningful reference in the process of choosing and applying methods for setting prices. It offers a “sanity check”, in the words of the judge in GE Capital of Canada.

The TPG (at the end of par. 1.35) try to indicate the limits of the authority of TNMM where it is stated “Therefore, in no event can unadjusted industry average returns themselves establish arm’s length conditions.” We suggest to go a step further and extend this statement to “industry average returns themselves, whether adjusted or unadjusted”. Otherwise, the TPG could end up in promoting presumptive taxation.

Companies should always be in a position to explain and justify their results in case that these end up outside the so-called “arm’s length range”. In the most usual approach to comparables searches, some 50% of the (qualifying) observations are *outside* that range. Technical adjustments applied can bridge some of the gaps. But explaining its own pricing behaviour as satisfying the ALP should take place on the basis of a company’s own results of its commercial and financial operations. The attribution thereof to the parties to the intercompany transactions is, at the end of the day, the real role of transfer pricing.

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Abbreviations:

TP = Transfer Pricing

TPG = OECD Transfer Pricing Guidelines

TAs = Tax Authorities

TNMM = Transactional Net Margin Method

BRDD = OECD Discussion Draft on Business Restructurings

ALP = Arm's Length Principle

MTC = Model Tax Convention

OECD Guidelines = OECD Guidelines of 27 June, 2000