

VIA ELECTRONIC TRANSMISSION TO:  
([Jeffrey.owens@oecd.org](mailto:Jeffrey.owens@oecd.org))

January 8, 2010

Dr. Jeffrey Owens  
Director  
Centre for Tax Policy and Administration  
Organization for Economic Co-operation and Development  
2 rue André Pascal  
75016 Paris  
FRANCE

Re: Comments Concerning Proposed Revisions to the OECD  
Transfer Pricing Guidelines (Draft of September 9, 2009)

Dear Dr. Owens:

The following comments are submitted by Caplin & Drysdale, a U.S. law firm, in connection with the above project. These comments were not prepared on behalf of any client or group of clients represented by the firm.

I. Introduction

The proposed revisions to Chapters I-III of the Transfer Pricing Guidelines have their origins in public Discussion Drafts concerning Comparability (May 2006) and the Use of Transactional Profit Methods (January 2008), comments from business groups and their representatives on the Drafts, and responses to detailed questionnaires issued by the OECD. In addition, the OECD met with business groups in November 2008 to discuss a range of issues relating to Comparability and the Use of Transactional Profit Methods. This process reflected the principle that, to function effectively, the Transfer Pricing Guidelines should be continuously monitored and revised to take account of current practices on the part of taxpayers and tax administrations.

The time is ripe for revisions to the Guidelines. In the fifteen years since the Guidelines were issued, cross-border transfer pricing has evolved dramatically, with

businesses and tax administrations devoting very significant resources to transfer pricing compliance and enforcement, respectively. In 1995, when the Guidelines were issued, only a few countries required transfer pricing documentation. Today, all OECD countries expect documentation of cross-border transactions between associated enterprises, and most OECD members have active APA programs to provide a means of resolving difficult transfer pricing cases on a prospective basis. Transfer pricing controversies continue, however, as evidenced by the number and size of double taxation cases that arise each year. The OECD is to be commended for its efforts to reduce controversy by reviewing and revising the Guidelines.

We recognize that the OECD has completed its background work, held consultations with stakeholders, and considered feedback to the two Discussion Drafts. At the same time, the OECD solicited comments concerning the proposed revisions to the Guidelines, noting that the revisions do not necessarily represent the final views of the organization or its members. Taking into account the current stage of this project, our comments focus mainly on technical and drafting issues. For example, in some cases it appears that the intent of a revision was lost in the process of integrating it into the existing Guidelines, or text that is retained from the existing Guidelines may be anachronistic or otherwise inconsistent with the proposed revisions. In a few cases, we have questions concerning the need for a proposed revision or the underlying conclusion that it reflects.

These comments use the following format. In general, a single paragraph or a group of paragraphs is briefly described and the basis for our concern is noted. Where possible, suggested edits are provided, using MS-WORD redline conventions. In some cases, additional wording changes are suggested that do not bear on the substance of the provision. Except as noted, references to the “Guidelines” are to the proposed revisions, i.e., the OECD discussion draft dated September 9, 2009. References to the “existing Guidelines” are to the official 2009 version published by the OECD.

## II. General Comments

### A. The OECD’s Conceptual Approach

As we understand it, this project has two primary goals: (1) to recognize that because the profit-based methods are frequently applied in modern transfer pricing practice, elimination of the “last resort” label currently applied to such methods may be appropriate; and (2) to emphasize the need, under all transfer pricing methods, for taxpayers and tax administrations to perform a rigorous comparability analysis that takes account of relevant similarities and differences between the controlled transactions and the uncontrolled transactions (or independent enterprises).

As the OECD has recognized, these two goals are “inextricably linked” with one another. For example, a taxpayer (or tax administration) applying the comparability factors in a diligent manner might find that it is not possible to identify comparable uncontrolled transactions, and thus conclude that application of a transactional profit method is appropriate. On the other hand, the conclusion that a transactional profit method is appropriate might be based on a less than rigorous review of the comparability factors. In the latter case, the same lack of rigor that led to the selection of a profit-based method may carry over to application of the method. At the extreme, such a transfer pricing analysis runs the risk of becoming a mere “validation” of transfer prices. A formalistic analysis of this type, particularly if it purports to be in accordance with the Guidelines, poses challenges to efficient tax administration.

Although the goals of the project are laudable, we have some general reservations concerning the editorial approach taken by the OECD. The apparent goal was to retain as much of the existing Guidelines as possible while making edits and reorganizing to reflect the technical input from Working Party 6. Whereas a complete re-draft of the Guidelines “from the ground up” would have been impractical, the more limited approach taken by the OECD seems to have resulted in some discontinuities and inconsistencies, as indicated below.

#### B. Documentation

The proposed revisions of Chapters II and III fail to adopt a uniform usage for the term “documentation.” Transfer pricing documentation is addressed separately in Chapter V of the Guidelines. In some cases (e.g., para. 1.48), the term refers to contracts in effect between associated enterprises, but in other cases it refers to contemporaneous transfer pricing documentation of the type that taxpayers might prepare to support the positions taken on an income tax return. We recommend that, to the extent possible, a uniform usage of this term be adopted throughout the Guidelines. For reference, the term “documentation” (putting aside direct cross-references to Chapter V) appears in the following paragraphs: 1.48, 1.77, 2.8, 2.79, 2.86, 3.4, 3.15, 3.23, 3.45, 3.53, 3.66, 3.68, and 3.70.

### III. Comments on Specific Provisions

#### A. Statement of the Arm’s Length Principle

We note the proposed revision to paragraph 1.9, with the language proposed to be added by the OECD highlighted.

The arm’s length principle has also been found to work effectively in the vast majority of cases. For example, there are many cases involving the purchase and sale of commodities and the lending of money where an

arm's length price may readily be found in a comparable transaction undertaken by comparable independent enterprises under comparable circumstances. **There are also many cases where a relevant comparison of transactions can be made at the level of financial indicators such as mark-up on costs, gross margin, or net profit margin.** Nevertheless, there are some significant cases in which the arm's length principle is difficult and complicated to apply, for example in MNE groups dealing in the integrated production of highly specialized goods, in unique intangibles, and/or in the provision of specialized services.

This paragraph considers, at a very general level, whether the arm's length principle provides an appropriate basis for dividing tax jurisdiction among two or more nations. The notion that transactional profit methods are consistent with the arm's length principle is central to the proposed revisions to the Guidelines. But it seems premature to introduce the concept at this point, before the necessary groundwork has been laid. We recommend that this sentence be deleted.

#### B. Comparability / Missing Data

The analytical framework proposed by the OECD calls for using “reasonably reliable comparables” as a means of selecting and applying the “most appropriate transfer pricing method in the circumstances of the case.” Paragraph 1.37, which is closely patterned on the existing Guidelines, notes that the importance of information concerning the uncontrolled comparables may vary depending on which transfer pricing method is used. Paragraph 1.38 observes that information concerning product characteristics may be especially important when a comparable uncontrolled price method is being applied. Although these observations are correct, paragraph 1.38 seems to focus too closely on the presence or absence of information, which might cause confusion.

Consider the following excerpt from paragraph 1.38:

Both the nature of the controlled transaction and the transfer pricing method adopted (see Chapter II for a discussion of transfer pricing methods) should be taken into account when evaluating the relative importance of any **missing piece** of information on possible comparables, which can vary on a case-by-case basis (see paragraph 1.37). Information on product characteristics might be more important if the method applied is a comparable uncontrolled price method than if it is a transactional net margin method. If it can be reasonably assumed that despite **some pieces of information being missing**, the uncontrolled transaction at issue is a reasonably reliable comparable, the comparison

should not be rejected just because of limitations on the **availability of information**.

Guidelines, paragraph 1.38 (emphasis added).

Potential concerns regarding comparability are not necessarily limited to missing or deficient information -- a point that is developed in the subsequent paragraphs in the Guidelines. Under the circumstances, the discussion in paragraph 1.38 appears somewhat simplistic. We suggest that the references in this paragraph to missing data, and perhaps the entire final sentence, could be eliminated or at least pared back.

Paragraph 1.53 of the Guidelines makes a similar point, noting that limitations on the availability of data are particularly relevant. Consider the following sentences from paragraph 1.53:

In practice, information available on contractual terms of potentially comparable uncontrolled transactions can be limited, especially where the taxpayer is not a party to such uncontrolled transactions. The importance of such **missing** information in establishing comparability depends upon the nature of the transaction that is being examined and the transfer pricing method, see paragraph 1.38. (Emphasis added).

In our view, the same point could be made more concisely, as follows:

In practice, information concerning the contractual terms of potentially comparable uncontrolled transactions may be either **limited or unavailable**, particularly where external comparables provide the basis for the analysis. The impact of deficiencies in information will differ depending on the type of transaction being examined and the specific transfer pricing method applied, see paragraph 1.38. (Emphasis added).

#### C. Hedging of Market Risks

Paragraph 1.49 (adapted from paragraph 1.27 of the existing Guidelines) refers to the tax administration's evaluation of the economic reality of a purported allocation of risks among associated enterprises. The paragraph observes that associated enterprises sometimes use derivatives or other means of minimizing market risks and recommends that the overall policy of the MNE with regard to such risks should be taken into account. The text of this paragraph is as follows:

Analysis is required to determine to what extent each party bears such risks in practice. When addressing the issue of the extent to which a

party to a transaction bears any currency exchange and/or interest rate risk, it will ordinarily be necessary to determine the extent, if any, to which the taxpayer and/or the MNE group have a business strategy which deals with the minimization or management of such risks. Hedging arrangements, forward contracts, put and call options, etc., both “on-market” and “off-market”, are now in common use. Failure on the part of the taxpayer bearing currency and interest rate risk to address such exposure may arise as a result of a business strategy of the MNE group seeking to hedge its overall exposure to such risks or seeking to hedge only some portion of the group’s exposure. The latter practice, if not accounted for appropriately, could lead to significant profits or losses being made which are capable of being sourced in the most advantageous place to the MNE group.

The basic points in this paragraph are still valid, but we suggest that the areas of emphasis may be somewhat different now than when the existing Guidelines were drafted. In this connection, it may also be worth noting that associated enterprises sometimes enter into hedging transactions with one another, and not merely with independent enterprises.<sup>1</sup> The following revisions are suggested:

Analysis is required to determine to what extent each party bears such risks in practice. ~~When addressing the issue of evaluating the extent to which a party to a transaction bears any currency exchange and/or interest rate risk, it will ordinarily be necessary to determine the extent, if any, to which~~ whether the taxpayer and/or the MNE group have in place a business strategy which deals with the minimization or management of such risks. Hedging arrangements, forward contracts, put and call options, swaps, etc., both ~~“on-market” and “off-market”~~, over-the-counter and special-purpose, are ~~now in~~ common use. Members of a MNE may also make use of hedges with other associated enterprises, particularly in the financial sector. If a party that bears a significant market risk declines to hedge its exposure, this may reflect a decision that it will assume the risk, or it may reflect a decision to have the risk hedged by another enterprise within the MNE group. These or other strategies with regard to the hedging or non-hedging of risks, if not accounted for in the transfer pricing analysis, could lead to an inaccurate determination of the profits in a particular jurisdiction.

---

<sup>1</sup> See OECD Report on the Attribution of Profits to Permanent Establishments (July 17, 2008), Part III, paras. 137-141.

#### D. Methods of Last Resort

Consistent with the proposed elimination of the “last resort” label for transactional profit based methods, the revisions also eliminate most statements to the effect that these methods are somehow less reliable than the other specified methods. However, at least one such instance appears to have been missed.<sup>2</sup> Paragraph 2.108 (based on paragraph 3.31 of the existing Guidelines) states as follows:

One other issue that arises for the transactional net margin method is that the method is typically applied to only one of the associated enterprises. This one-sided aspect does not distinguish the method from most other methods, given that the resale price and cost plus methods also have this feature. **However, the fact that many factors unrelated to transfer prices can affect net margins and can render the transactional net margin method less reliable heightens the concerns over the use of this method . . . .** (Emphasis added).

The highlighted sentence seems unnecessary. Alternatively, if the sentence is kept, the tone might be moderated as follows:

Like the resale price and cost plus methods, the TNMM typically is applied to only one of the associated enterprises. However, the fact that many factors unrelated to transfer prices can affect net margins, in conjunction with and can render the transactional net margin method less reliable, heightens concerns over the one-sided nature of the analysis under this method, can affect the overall reliability of the TNMM.

#### E. Arm’s Length as an Adjective

In discussing the arm’s length principle, there is a tendency to use the term “arm’s length” in both technical and colloquial senses. For example, paragraph 1.51 refers to “arm’s length dealings,” and paragraph 1.52 refers to “dealings between independent enterprises,” and the same meaning seems intended in both places.<sup>3</sup> We recommend that the Guidelines adopt a uniform meaning of the term “arm’s length,” if only to avoid potential confusion.<sup>4</sup>

---

<sup>2</sup> The reference to “so-called ‘comparable profits methods’” in paragraph 2.60 also seemed unnecessarily pejorative.

<sup>3</sup> Other instances include paragraph 1.62 of the Guidelines, which refers to an “arm’s length arrangement” and a “party operating at arm’s length.”)

<sup>4</sup> Some text that is proposed to be retained from the existing Guidelines uses “arm’s length” in yet another sense – complying with the arm’s length principle. E.g., Paragraph 3.57 (“[T]wo methods that

On a related point, we note that the existing Guidelines treated the term “dealing” as synonymous with “transaction.” After the OECD’s work on attribution of profits to permanent establishments, however, the term “dealings” might now be considered a term of art that refers to transactions (either actual or notional) between different parts of a single enterprise.<sup>5</sup> It may be advisable to use a different term, or at least to note the difference in meaning.

F. Economic Circumstances

The statement regarding geographic markets in paragraph 1.54, which is adopted from paragraph 1.30 of the existing Guidelines, seems tautological (i.e., comparability requires comparable markets). We recommend that this principle be restated to conform to the more refined description of comparability provided elsewhere in the Guidelines (as revised). Set forth below are the proposed text and a suggested revision.

Paragraph 1.54 (first sentence):

Arm’s length prices may vary across different markets even for transactions involving the same property or services; therefore to achieve comparability requires that the markets in which the independent and associated enterprises operate are comparable and that differences do not have a material effect on price or that appropriate adjustments can be made. (Emphasis added)

Suggested revision:

The prices observed for transfers by independent enterprises of identical property or provision of identical services may differ from one geographic market to another. Identification of reasonably reliable comparables requires that the markets in which the independent and associated enterprises operate are comparable, which in this context means that differences between the markets do not have a material effect on prices or that it is possible to make adjustments for any differences that do have such a material effect.

---

attain similar degrees of comparability may be used to evaluate the arm’s length character of a controlled transaction.”)

<sup>5</sup> See OECD Report on the Attribution of Profits to Permanent Establishments (July 17, 2008), Part I, para. 209 (“In an Article 9 situation, there are ‘controlled transactions’ between associated enterprises . . . . In the PE situation there are ‘dealings’ rather than actual transactions that govern the economic and financial relationships between the PE and another part of the enterprise.”)

G. Selecting the Most Appropriate Transfer Pricing Method to the Circumstances of the Case

Paragraph 2.1 introduces the concept of the “most appropriate transfer pricing method under the circumstances of the case.” This paragraph describes the key change in analytical approach that the OECD has proposed. For the sake of clarity, we propose several minor changes, as indicated below:

Parts I and II of this Chapter respectively describe “traditional transaction methods” and “transactional profit methods” that can be used to establish whether the conditions imposed in the commercial or financial relations between associated enterprises are consistent with the arm’s length principle. The selection of a transfer pricing method ~~always aims at finding~~ is premised on identifying the most appropriate method for a particular case. For this purpose, ~~it~~ the selection process should take account of the respective strengths and weaknesses of ~~each of~~ the OECD recognized methods; ~~of~~ the appropriateness of ~~the~~ specific methods 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~~ needed to apply the selected method and / or other methods; and ~~of~~ the degree of comparability ~~of~~ between controlled and uncontrolled transactions, including the reliability of comparability adjustments that may be needed to eliminate differences between them. No one method is suitable in every possible situation, ~~and the applicability of any particular methods need not be disproved nor is it necessary to prove that a particular method is not suitable under the circumstances.~~<sup>6</sup> See paragraph 3.2 for a discussion of the meaning of the phrase “reasonably reliable comparables.”

In this context, the Guidelines might also note that the provision of services between associated enterprises can be evaluated on a “cost only” basis, subject to the guidance in Chapter VII of the Guidelines with respect to intra-group services.<sup>7</sup> This would be less complex than the alternative, which is to identify the “cost only” approach for services as a distinct transfer pricing method. If the Guidelines are silent on this point, the historical cost-only approach for services could potentially be viewed as a non-specified transfer pricing method, which is presumably not the OECD’s intent.

Paragraph 2.4 states that it is not appropriate to apply a transactional profit method solely because it is difficult to obtain data concerning uncontrolled comparables.

---

<sup>6</sup> Note: this sentence, as edited, was moved from a position earlier in the same paragraph.

<sup>7</sup> See paragraphs 7.33 – 7.34 of the existing Guidelines.

This paragraph introduces the important concept that profit-based methods may become “default” methods if deficiencies in data concerning comparable uncontrolled transactions are given too much weight. Nonetheless, this paragraph, in particular the attempt to connect this concept to the general reliability standard, is difficult to follow. The paragraph and a suggested revision are as follows:

Paragraph 2.4:

However, the transactional profit methods may not be applied automatically simply because there are difficulties in obtaining data. The same criteria, as listed at paragraph 2.1, that should have been assessed in arriving at the conclusion that it was not possible to reliably apply a traditional transaction method must be reconsidered when evaluating the reliability of a transactional profit method.

Suggested revision:

However, it is not appropriate to apply a transactional profit method solely because data concerning uncontrolled transactions are difficult to obtain or incomplete in one or more respects. The same criteria listed in paragraph 2.1 that were used to reach the initial conclusion that none of the traditional transactional methods could be reliably applied under the circumstances, must be considered again in evaluating the reliability of the transactional profit method.

Paragraph 2.6 states that the transactional profit methods do not provide a basis for a tax administration to impose additional tax on a company that earns profits lower than the average, much less for it to under-tax a company that makes higher-than average profits. This paragraph, adopted almost verbatim from paragraph 3.3 of the existing Guidelines, makes an important point. It might be useful to include a cross-reference here to paragraph 1.35 of the Guidelines (final sentence), which states that in no event can “unadjusted industry average returns” establish arm’s length conditions, as both paragraphs make related points.

H. Transactional Profit Methods as a Proxy for Arm’s Length Conduct

1. In general

The existing Guidelines state that transactional profit methods are acceptable “only insofar as they are compatible with Article 9 of the OECD Model Tax Convention.” See paragraph 3.3 of the existing Guidelines (corresponding to paragraph 2.5 of the Guidelines). This statement, which the OECD proposes to retain, may be important to OECD members that continue to have reservations concerning the

reliability of transactional profit-based methods as a measure of arm's length prices. Under the traditional transaction-based methods, the linkage between the prices of controlled transactions and the prices of transactions between independent enterprises is direct, but under the transactional profit methods the linkage is less direct, and in some cases it is only theoretical (e.g., for profit split methods). Under the circumstances, repeated references to the consistency between the transactional profit methods and the arm's length principle no longer seem appropriate or necessary. Consequently, we propose the following edits to paragraph 2.5:

Methods ~~that are~~ based on profits ~~can be accepted~~ are considered reliable only to the extent that ~~insofar as~~ they are applied in a manner consistent with compatible with the principles in Article 9 of the OECD Model Tax Convention, especially with regard to comparability between the associated enterprise and the transactions or independent enterprises evaluated as comparables. ~~This is achieved by applying the method in a manner that approximates arm's length pricing.~~ Under these methods, the application of the arm's length principle is generally based on a comparison of the price, margin or profits from ~~particular controlled specific~~ specific transactions between associated enterprises with the price, margin or profits ~~from~~ observed in comparable transactions between independent enterprises. In the case of a transactional profit split method, ~~it~~ the application is based on an approximation of the division of profits that independent enterprises would likely expected to realize from engaging if they engaged in the same or similar transactions (see paragraph 2.62).

This same concept is repeated elsewhere in this section, using somewhat different terminology. These references could be eliminated or scaled back considerably.

## 2. Profit as a "condition made or imposed"

Historically, the Guidelines noted that independent enterprises seldom (if ever) enter into transactions in which profits constitute a term of the transaction. See paragraph 3.2 of the existing Guidelines. This is a valid observation, but its relevance seems diminished if, as proposed, the Guidelines adopt a more refined discussion of comparability. Consequently, we suggest the following edits to paragraph 2.61:

A transactional profit method examines the profits that arise from ~~particular specific controlled~~ specific transactions between associated enterprises. The transactional profit methods for purposes of these Guidelines are the transactional profit split method and the transactional net margin method. ~~It is unusual to find enterprises entering into transactions in which profit is a condition "made or imposed" in the transactions. Nonetheless,~~

Analysis of the profit arising from specific controlled transactions between associated enterprises can be a relevant indicator may indicate of whether the transactions ~~was~~ were affected by conditions that differ from those that would have been made by independent enterprises in otherwise comparable circumstances.

3. Arm's length nature of transactional profit split method

The existing Guidelines note that use of a transactional profit split method is justified on the grounds that the method reflects the allocation of profits that independent enterprises might agree to, if they had engaged in transactions similar to those between the associated enterprises. For example, paragraph 3.5 of the existing Guidelines states:

Where transactions are very interrelated it might be that they cannot be evaluated on a separate basis. Under similar circumstances, **independent enterprises might decide to set up a form of partnership and agree to a profit split**. Accordingly, the profit split method seeks to eliminate the effect on profits of special conditions made or imposed in a controlled transaction . . . by determining the **division of profits that independent enterprises would have expected to realize** from engaging in the transaction or transactions. The profit split method first identifies the profit to be split for the associated enterprises from the controlled transactions in which the associated enterprises are engaged. It then splits those profits between the associated enterprises on an economically valid basis that approximates the **division of profits that would have been anticipated and reflected in an agreement made at arm's length** . . . . (Emphasis added)

This same theme is repeated elsewhere in the existing Guidelines. Paragraph 3.21 makes the related but different point that the transactional profit-split method may replicate the division of operating profits that would result at arm's length, i.e., reflecting a notional bargaining process between the associated enterprises.

The proposed revisions to the Guidelines adopt the same justification for the profit split method, i.e., that it replicates the allocation of profits that independent enterprises might make if they operated under conditions similar to those of the associated enterprises.<sup>8</sup> But, this justification was arguably more important when the transactional profit split carried the "last resort" label. With that label removed, it

---

<sup>8</sup> Please refer to the following paragraphs in the Guidelines: 2.62, 2.64, 2.65, 2.66, 2.69, 2.70, 2.72, 2.73, 2.76, 2.83, and 2.93.

seems that these repeated references to the profit split method as consistent with arm's length conduct can be deleted.

We recognize that some commentators view the profit split method as a quasi-formulary approach that is inconsistent with the arm's length principle.<sup>9</sup> In this context, the Guidelines might observe that: (1) profit split methods have long been used to resolve difficult transfer pricing cases; and (2) such methods are premised on indentifying a notional "arm's length" split of operating profits. It may also be worth noting that a transfer pricing method that relies on an allocation formula does not constitute "global formulary apportionment."<sup>10</sup> Repeated references to the notional or hypothetical behavior of independent enterprises, in contrast, do not necessarily confirm that the profit split method is consistent with the arm's length principle.

#### I. Data from taxpayers' own operations ("internal data")

Paragraph 2.95 deals with the use of internal data of the associated enterprises as a basis for splitting profits under the transactional profit split method. We suggest a minor edit to the first sentence of this paragraph, as follows:

Where comparable uncontrolled transactions of sufficient reliability are lacking to support the division of the combined profit, consideration should be given to internal data, which may ~~successfully be used as a~~ in some cases provide a reliable means of establishing or testing the arm's length nature of the division of profits.

We have some general reservations concerning the proposed treatment of internal data in paragraphs 2.95 through 2.99. Paragraph 2.95 concludes that internal measures should be used only when comparable uncontrolled transactions that would provide a reliable basis for the profit split are not available. In fact, internal measures have long been used to split operating profits, particularly in certain specialized contexts, such as integrated global dealing operations. In some settings, attempting to identify comparable uncontrolled transactions as a metric for the profit split may be futile, as all parties concerned may know that reliable data for this purpose are unavailable.

---

<sup>9</sup> E.g., Lee Sheppard, "Xilinx and the Future of Transfer Pricing," Tax Notes Today, 1295, 1299 (June 15, 2009) ("Profit split is formulary apportionment by another name, but it is convenient when there are no comparable transactions, as is often the case with unique intangibles that feature in transfer pricing disputes."). See also Reuven S. Avi-Yonah, Kimberly A. Clausing, and Michael C. Durst, Allocating Business Profits for Tax Purposes: A Proposal to Adopt a Formulary Profit Split, 9 Florida Tax Review 497 (2009) (proposing a sales-based formula for allocation of residual profits).

<sup>10</sup> The relevant distinction is that global formulary apportionment relies on a formula that is "predetermined and mechanistic." See paragraph 1.17 in the Guidelines and paragraph 3.59 in the existing Guidelines.

#### J. Scope and Detail of Profit Split Discussion

The number of paragraphs that deal with the transactional profit split method has doubled, from 19 in the existing Guidelines to 38 in the Guidelines as revised. The profit split method is complex, and its application of course depends on specific factual circumstances, but it might be more useful for the Guidelines to state general principles and provide a few illustrations, rather than seeking to cover the entire waterfront. In our view, the discussion of profit split methods could be shortened considerably, but we have not prepared specific editing suggestions in this regard.

One or more paragraphs in this section might be deleted, including several proposed to be retained from the existing Guidelines. For example, we are not aware of any recent applications of a discounted cash-flow (paragraph 2.77) or a return on capital employed analysis (paragraph 2.99) in the context of the profit split methods.<sup>11</sup> In general, text should not be carried over from the existing Guidelines unless it is relevant to current transfer pricing practices.

#### K. Transactional Net Margin Method

The introductory paragraph in this section (paragraph 2.100), which is adapted from paragraph 3.26 of the existing Guidelines, states that to the extent possible a TNMM should be applied by using internal comparables. The fifth sentence in this paragraph states:

Where this is not possible, the net margin that would have been earned in comparable transactions by an independent enterprise (“external comparables”) may serve as a guide.

This sentence seems inconsistent with the OECD’s proposed revisions and indeed with modern practices under the TNMM and similar methods. Assuming that the OECD now recognizes that a “robust” application of the TNMM can rely on external comparables, this paragraph should be strengthened to make that clear.

#### L. Comparability Under the TNMM

We suggest several edits to paragraph 2.110, only some of which are substantive in nature. The substantive edits here would clarify that under the TNMM the primary factors that affect reliability are those that affect the amount of (financial)

---

<sup>11</sup> The interim 1993 version of the U.S. transfer pricing regulations provided for a “capital employed allocation rule” under the profit split method. See Notice of Proposed Rulemaking, INTL-401-88, 1993-1 C.B. 825, 830. The final U.S. regulations, adopted in 1994, did not include that approach.

operating profit reported by the uncontrolled comparables – rather than the transactional details of the underlying uncontrolled transactions, as the current text seems to suggest. Our suggested edits appear below:

In all cases, a full comparability analysis must be performed in all cases in order to selecting and applying the most appropriate transfer pricing method, and the process for of selecting and applying a transactional net margin method should not be no less reliable rigorous than for any other methods. As a matter of good practice, the typical process for identifying comparable transactions and using data so obtained which that is described at paragraph 3.5 or any equivalent process designed to that ensures a robustness of the analysis should be followed when applying a transactional net margin method, just as it would with any other method. That being said, it is recognized that in practice the level amount of information available on the factors affecting external comparable transactions (in this case, the factors that bear on the financial profits reported by the independent enterprises identified as comparables) is often may be limited. Under these circumstances, determining a reliable estimate of an arm's length outcome requires may call for flexibility and the exercise of good judgment.

M. Start-up and Termination Costs

Paragraph 2.126 of the Guidelines addresses the treatment of start-up and termination costs in the context of a TNMM. This has been a contentious issue in several bi-lateral Competent Authority/MAP relationships. The paragraph observes that the analysis of these costs calls for review of the facts and circumstances, that various treatments are possible (exclusion, pass-through, charge-through with mark-up), and that one relevant factor is whether one of the associated enterprises performs the activity for the exclusive benefit of the other associated enterprise, or if the entity has other customers. These considerations are relevant, but overall the paragraph fails to provide much in the way of concrete guidance to taxpayers or tax administrations. We recommend that the paragraph be deleted.

N. Net Profit Margin Indicators

The proposed revisions go into considerable detail concerning the selection and calculation of net profit margin indicators under the TNMM – matters that receive little attention in the existing Guidelines. For the most part, the proposed additions adopt concepts from the Issues Notes concerning profit based methods.

Paragraph 2.141 addresses the Berry ratio and identifies several preconditions that need to be satisfied where that indicator is used:

- The value of the functions performed in the controlled transaction (taking account of assets used and risks assumed) is proportional to the operating expenses;
- The value of the functions performed in the controlled transaction (taking account of assets used and risks assumed) is not materially affected by the value of the products distributed, *i.e.* it is not proportional to sales, and
- The taxpayer does not perform, in the controlled transactions, any other significant function (*e.g.* manufacturing function) that should be remunerated using another method or financial indicator.

The first test (value proportionate to operating expenses) seems highly subjective, and the second test (value of sales functions not affected by value of products) requires a party seeking to use the Berry ratio to “prove a negative,” which generally is impossible. We recommend that this paragraph be revised, although we do not have specific editing suggestions at this time. As currently worded, the paragraph provides a basis for a tax administration (or a taxpayer) to prevent application of the Berry ratio in most if not all cases, although that was presumably not the OECD’s intent.

#### O. Other Guidance

Paragraph 2.143, adopted from similar text in the existing Guidelines, states that under a TNMM analysis, it is necessary to ensure that the profits examined relate to the specific transactions between the associated enterprises that are being analyzed. Although this is a valid point, the paragraph refers to the “profits attributable to” the controlled transactions. It may be advisable to use a different term, to avoid any unintentional reference to the concept of “profits attributable to a PE” under Article 7 of the OECD Model Tax Convention.

#### P. Choice of Tested Party

Paragraph 3.18 indicates that when applying the cost plus, resale price, or TNMM, one must select the associated enterprise to which the relevant financial indicator will be applied. This is true with respect to the TNMM, but superfluous with respect to the cost plus and resale price methods. A cost plus method is by definition applied to a manufacturer or a service-provider, and a resale price method is by definition applied to a reseller of tangible property, so the identification of the tested party is integral to the choice of method, and the prices of the controlled

transaction, once determined, bind both parties. Under a TNMM, it is possible to test either party to the controlled transaction. For example, in the case of services, one could examine the profits of the service-recipient or the service-provider, and either approach could be used to evaluate whether the transaction conforms to the arm's length principle.

Q. Internal Comparables

For the sake of clarity, we propose several minor changes to paragraphs 3.27 and 3.28, as indicated below:

3.27 Step 4 of the ~~typical~~ analytical process described at paragraph 3.5 ~~is calls for~~ a review of any existing internal comparables that may exist.  
\* \* \* \* \*

3.28 On the other hand, internal comparables are not ~~always~~ necessarily more reliable in every case and it is not the case that any nor will every transaction between a taxpayer and an unrelated ~~taxpayer can be regarded as party constitute~~ a reliable comparable for controlled transactions that are carried on by the same taxpayer.

R. Information Not Disclosed to Taxpayers (Secret Comparables)

Many business representatives expressed their opinion that so-called “secret comparables” should play no role in transfer pricing.<sup>12</sup> Although we fully support that view, we do not wish to revisit the underlying debate, much less to second-guess the resolution proposed by the OECD. However, taking paragraph 3.35 at face value, it seems incomplete. First, it suggests that the data used by the tax administration are at the same time: (1) not available to the taxpayer; and (2) available to the taxpayer for purposes of judicial review.<sup>13</sup> Second, the paragraph fails to describe the (presumably very limited) circumstances in which a tax administration might make use of data that are not disclosable to the taxpayer. The following suggested edits to paragraph 3.35 address these points:

In some cases, the a tax administrators may have information available to them from examinations of other taxpayers or from other sources of information that may not be disclosed available to the taxpayer. On occasion, the tax administrator may use such data for certain limited

---

<sup>12</sup> E.g., BIAC Comments on Draft Issues Notes Regarding Comparability, Dec. 18, 2006, at 6; KPMG LLP Comments on Draft Issues Notes Regarding Comparability, Nov. 30, 2006, at 3.

<sup>13</sup> Under certain legal systems, a taxpayer might have greater access to data in a judicial proceeding (for example, under a judicial protective order) than in the proceeding before the tax administration. If that is the situation contemplated in this paragraph, the assumption should be stated clearly.

purposes, such as to identify aberrant transfer pricing practices for purposes of allocating audit resources or identifying specific audit targets. However, it would be patently unfair for a tax administrator to apply a transfer pricing method on the basis of such data unless the tax administration was able, within the limits of its applicable domestic confidentiality requirements to provided for permit disclosure of such data to the taxpayer, so that there would be an adequate opportunity for thus affording the taxpayer an opportunity to defend its own position and to safeguard obtain effective judicial review by the courts of any transfer pricing adjustment.

#### S. Purpose / Reliability of Comparability Adjustments

Paragraphs 3.49 – 3.51 in effect provide a laundry-list of “worst practices” concerning comparability adjustments, which seems inconsistent with the general approach of the Guidelines. These paragraphs might be re-structured to include more affirmative statements. In addition, paragraph 3.52 struck us as difficult to follow. Some suggested edits to these paragraphs are provided below:

3.49 Comparability adjustments should be considered if where (and only where if) they ~~can be~~ are expected to increase the reliability of the results. There are in particular Relevant considerations in this regard in relation to include the quality of the data being subject to adjusted adjustment, the purpose of the adjustment, performed and the reliability of the approach used to make the adjustment performed.

3.50 It is not always the case that ~~third party data warrant the proposed adjustments are warranted.~~ In particular, sophisticated adjustments may be questionable when basic comparability criteria are only broadly satisfied. For instance, it may not be worth adjusting data for an identified an adjustment for differences in accounts receivable would not be warranted if major differences in accounting standards were also present that could not be resolved in the first place comparability is likely to be affected by significant uncertainties that could not be resolved in the accounting standards applied by third parties. Likewise, If the search for comparables has major shortcomings, sophisticated adjustments should not be are sometimes applied to create the wrong false impression that the outcome of the comparables search is “scientific,” reliable and accurate. In a similar vein, The need to perform of numerous or large very material adjustments to key comparability factors might not be acceptable. Too many adjustments or adjustments that too greatly affect the comparable may indicate that the

third party transactions ~~being adjusted~~ lack fundamental comparable comparability.

3.51. It bears emphasis that C-comparability adjustments do not need to be, and in fact should not be, performed to correct are only appropriate for differences that will have no a material effect on the comparison. There will always be Some differences will invariably exist between the taxpayer's controlled transactions and each of the third party comparables. A comparison should not be rejected just because of may be entirely appropriate despite a unadjusted difference for which no adjustment is possible, if such provided that the difference can is reasonably be assumed not expected to have no a material effect on the comparability reliability of the comparison.

3.52 In the view of OECD member countries, do not support the notion that it is not appropriate to view some comparability adjustments, such as for differences in levels of working capital adjustments, should be regarded as "routine" and uncontroversial, while some other and to view certain other comparability adjustments, such as those sometimes made to account for country risk, may be considerably as more subjective, so that it would not be unreasonable to expect more effort to be put into justifying their use and therefore subject to additional requirements of proof and reliability. Every adjustment should be expected to improve comparability or it should not be made. In the final analysis, the only adjustments that should be made are those that are expected to improve comparability.

#### T. Annex III (Working Capital Adjustments)

Annex III to Chapter II, Part III provides an example of the comparability adjustment that may be performed for differences in levels of working capital. The description of the rationale for this adjustment seemed somewhat imprecise. As commonly understood, the adjustment takes account of differences in levels of working capital based on the assumption that such differences have a measurable effect on the relative operating profits of the tested party and the uncontrolled comparables.<sup>14</sup> In contrast, the Annex seems to suggest that the adjustment relates to the interest expense or interest income of the tested party.<sup>15</sup> It suggests that the

---

<sup>14</sup> See generally Brian C. Becker, "Capital Adjustments: A Short Overview," 7 BNA-Tax Management Transfer Pricing Report 613 (1997); Scott Newlon, "Dealing with Interest-Free Comparables When Applying the Comparable Profits Method," 3 BNA-Tax Management Transfer Pricing Report 533 (1994).

<sup>15</sup> The deduction of interest expense from taxable income may be limited under domestic law, including by thin capitalization rules and by "matching" rules applicable to associated enterprises. Although a transfer pricing adjustment for differences in levels of working capital is determined by reference to a

comparability adjustment relates to “understate[ment of] interest expense” or “overstate[ment of] interest income.” (Guidelines, Annex II, para. 3). We recommend that the explanation in paragraphs 2-4 of the Annex indicate that that adjustment for differences in working capital uses notional or imputed interest as a means of quantifying the effect of differences in levels of working capital on operating profits.

The example in the Annex does not try to illustrate the complexities that may arise when performing the working capital adjustment. For example, the calculation applies a single interest rate to “net working capital” (accounts receivable plus inventory minus accounts payable). In practice, different interest rates may be appropriate for the separate components of working capital. To avoid any confusion on this point, we recommend several changes to the second bullet-point under section 8 of the Annex:

~~A major issue in making working capital adjustments is the question of which involves selection of the appropriate interest rate (or rates) to use. The rate (or rates) to be used is should generally be determined by reference to an arm’s length the rate(s) of interest rate applicable to a commercial enterprise operating in the same market as for the tested party. In most cases a commercial loan borrowing rate will be appropriate, such as a prime lending rate or an interbank rate plus an appropriate premium. In cases where the tested party’s working capital balance is negative (that is, Payables > Receivables + Inventory), a different rate may be considered in some cases appropriate. The rate used in the above example uses an interest rate based on what reflects the rate at which TestCo is able to borrow funds at in the its local market. This example also assumes that the same interest rate is applied to appropriate for payables, receivables, and inventory, but that may or may not be the case in practice. Where different rates of interest are applied to individual classes of assets or liabilities, the calculation may be considerably more complex than shown above.~~

---

notional interest amount, it does not constitute an actual adjustment to the interest expense or interest income of the tested party.

Thank you for your consideration of these comments.

Very truly yours,

/s/

John M. Breen  
Neal M. Kochman