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Proposed revision of Chapters I - III of the Transfer Pricing Guidelines

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I. General impressions

The revision was undoubtedly necessary to update the TPG and therefore to take into account existing realities such as the importance of the TNMM, which has been widely used in practice despite its status as a method of last resort. It was also useful to describe how the comparability analysis is implemented in practice (in particular the search for external comparables and, where necessary, making appropriate adjustments).

However, in addition to the description of what is done in practice we would have expected to see more innovative guidance on at least the following points:

- More weight should be given to internal data and contribution analyses (including the so-called value-chain analysis), especially when such analyses are undertaken for the purpose of an ex ante profit split and eventually for the determination of transfer prices at the beginning of each budget period. Indeed prices should be determined in advance as independent parties would normally do. Accepting such an approach would not prevent tax authorities from applying the TNMM or any other method as a sanity test.

Such internal analyses could also be supported by having recourse to what is taught in price theory. So, for example, while in a bilateral oligopolistic market situation the bargaining power of the parties to a transaction will be pretty balanced, the bargaining power will be totally unbalanced if the market situation shows that one partner is operating in a fully competitive environment while the other enjoys a quasi monopolistic position. Further considerations on the comparability factor “Economic circumstances” would be helpful (e.g. elasticity of supply and demand depending on whether the goods or services are unique and of vital necessity or if there are equivalent substitute goods or services). Such considerations help determining how expected total profits would have been allocated between independent third parties.

Unless a CUP exists and is really applicable in light of all other relevant comparability factors, unequivocal preference should be given to internal analyses (obviously including internal comparables where these exist) or to individually identified and carefully selected external comparables. In other words, the “additive approach” should prevail over the “deductive approach” where external comparables have to be used (paragraphs 3.39 – 3.45). However, suggesting a general need for aggregated statistical data (stemming from databases) would cause considerable compliance costs and transform the arm’s length principle into a statistical exercise without having a close link to the taxpayer’s specificity.

- It is our wish that the TPG should be periodically revised and updated so as to keep pace with the evolution of theory and practice. Indeed several paragraphs have practically remained unchanged for decades (e.g. The effect of government policies; Losses; Transfer prices and customs valuations, Intentional set-offs). Moreover, the increasing success of the TNMM to the detriment of the traditional cost plus and resale price methods should trigger a reconsideration of the rationale behind these two traditional methods which, in our view, are still closer to the arm’s length principle than the TNMM where the risk and profit potential related to the functions performed and assets used is fully assumed. For these and possibly also other reasons a revision of the TPG should be envisaged every three to five years to make sure that all paragraphs are still valid in practice.

Notwithstanding the preceding general impressions and the subsequent specific remarks, we would like to commend the OECD for the excellent work done in this difficult area of international taxation.

II. Specific observations and some re-drafting proposals

Chapter I

Paragraph 1.42: Functional analysis

The last sentence of old paragraph 1.20 said: “It will also be relevant to determine *in what juridical capacity* the taxpayer performs its functions.” This idea had been taken over from paragraph 17 (functional analysis) of the 1979 Transfer pricing Report: “it may be important not only to find out which entities perform the different functions but also to ascertain *in what capacity* they perform these functions – whether for example with regard to selling activities as principal (accepting all the risks and entitled to all the profits of the activity) or as agent (with limited risks and for limited return.” The recent OECD Report on the Attribution of profits to permanent establishments reconfirms in Part I, paragraph 21 (second sentence) the importance of the terms “in what capacity”. The terms “juridical capacity” used in the 1995 TPG acknowledges the basic right of free choice of the entrepreneurial role (capacity) when performing functions, using assets and managing risks. We remember that the term “juridical” came in to favor the understanding by German (“*in welcher Rechtsposition*”) and French (“*à quel titre*”) speaking delegates. Moreover, it is clear in our mind that the term “juridical” was meant to reconfirm the freedom of taxpayers to decide in their contracts what entrepreneurial roles they want to assume. This very important statement would be lost if the new last sentence of paragraph 1.42 was left as it stands, which would be a step backwards.

For these reasons we propose what follows:

The last sentence of paragraph 1.42 should be slightly modified and moved to the paragraphs dealing with “contractual terms” (1.51-1.53): **“It will also be relevant to determine the legal rights and obligations of the taxpayer *deriving from the contractual terms.*”**

The last sentence of old paragraph 1.20 must in our view be put back in the new paragraph 1.42, reading: **“It will also be relevant to determine *in what juridical capacity the taxpayer performs its functions.*”** Alternatively the term “juridical” might be deleted or replaced by “entrepreneurial” if this were more agreeable. The sentence would then read as follows: **“It will also be relevant to determine *in what (entrepreneurial) capacity the taxpayer performs its functions.*”**

Paragraph 1.47: Functional analysis

The first sentence sounds somewhat odd. There is no need to say that the assumption of risks determines to some extent the allocation of risks between the parties We propose therefore to shorten the wording in brackets and just say: “..... **(taking into account the assets used) will determine to some extent the allocation of risks**”

Paragraphs 1.63 – 1.68: Recognition of the actual transactions undertaken

We are missing a clear statement saying that non-recognition of actual transactions begins where the discrepancy between substance and form is so important that such discrepancy cannot be reliably eliminated through a comparability analysis and appropriate comparability adjustments. Pursuant to this, we wonder if in the first example given in paragraph 1.64 (thin capitalization) the non-recognition of interest deductions, which may be a fraction of the total interest paid to a related lenders, is not closer to a comparability adjustment than to a restructuring or a non-recognition of the transaction. More examples would be helpful.

Chapter II

Paragraph 2.11: Use of more than one method

We have the feeling that a secondary method to corroborate a primary method is more than a plausibility or sanity test. While a sanity test can be undertaken on the basis of any method, the use of a corroborating method implies serious divergent views at the level of the comparability analysis. Should our understanding be correct, then it would be helpful if the report could expand on these points.

Paragraph 2.131: Cases where the net profit is weighted to sales

We doubt if the term “sometimes” in the first sentence is appropriate. Indeed when applying the TNMM to a distributor, tax authorities **frequently** weight the net profit to sales.

Paragraph 2.137-2.138 : Cases where the net profit is weighted to assets

Experience shows that this approach raises considerable comparability issues in order to determine the appropriate return on assets or capital employed. The lifetime of the fixed assets may in such cases strongly vary depending on the nature of the asset-intensive manufacturing activity. An arm's length rate of return might only be appropriate if it could be applied on the long-term average book (or possibly market) value of the fixed assets. The fact that such value will be extremely high in the initial phase of the enterprise, probably fair in its middle phase and certainly insufficient in its final phase will in any fiscal year hardly produce a realistic result. Modifying the rate of return according to the age of the fixed assets might temporarily be a solution but there is always a risk that at one moment in the lifetime of the manufacturer the link between the market value of its production (or manufacturing service) and its taxable profit gets totally lost. Therefore, we think that these cases should be handled with caution and that their taxable results should be regularly tested by means of more than one method.

Paragraphs 2.140-2.142: Berry ratios

It should not be given the impression that a Berry ratio is something different than a TNMM where the net margin is weighted to distribution operating expenses. It therefore carries in itself all the potential weaknesses of the cost plus methods with their risks to penalize efficiency (low costs, high sales) and to offer a premium to inefficiency (high costs, modest sales).

Chapter III

Paragraph 3.3: Performing a comparability analysis

Whether the reasonableness of the compliance effort provides a safe harbor or not is a tricky question; a straight answer should therefore be avoided. The yardstick for reasonable compliance efforts will in practice depend on the importance of the taxpayer. Tax authorities can not require from small- and medium-sized multinational enterprise what they may legitimately expect from huge multinational enterprises.

Reasonably reliable comparables will generally be found and used if reasonable compliance efforts are made before determining one's transfer pricing method and the respective

prices. Clearly after the event more reliable comparables will often be identified and used against the taxpayer; it would be unfair to use them retroactively.

Paragraph 3.6: Typical process

We think that in the fourth sentence the terms “low risk” before “distributor” are confusing and should be deleted. If a fully fledged manufacturer knows from the very beginning that the other partner is a low risk distributor it would hardly look for a CUP.

Paragraphs 3.30-3.33: Databases

In our view, the recourse to databases should not be intended as a primary assessment technique deriving from external comparables. Databases may nevertheless provide material information for the purpose of applying a corroborating method where no agreement would otherwise be reached on the basis of the primary method. In our mind it is self-evident that the taxpayer has the right to decide which (primary) transfer pricing method is the most appropriate in its specific case. Again, nothing should prevent tax authorities to use statistical data as a plausibility test with respect to the reported results. However, databases should be used with extreme caution when they are meant to serve other purposes.

Paragraph 3.35 : Information undisclosed to taxpayers

This paragraph should not give the impression that the ex post disclosure of secret comparables (normally in a MAP or an APA-procedure) dissipates the two fundamental problems raised by the use of secret comparables. Hindsight is one of the two problems. The other is the relevance of such “comparables”. Experience has indeed repeatedly shown that such information often remains secret - in other words is not known to the taxpayer – just because the cases it refers to are marginal in comparison to the taxpayer’s sales volume and market share. Had the information on these cases been publicly available, neither the “additive” nor the “deductive approach” would have taken them into account.

Paragraphs 3.47-3.48: Different types of comparability adjustments

In practice one has to face different types of balance sheet and P&L adjustments. The working capital adjustment as illustrated in Annex III to Chapter III is a welcome clarification. However, in practice, even if such adjustments are made, they hardly have a significant

impact on the result of a MAP or an APA. It would therefore be a positive message if OECD could take the commitment to further explore adjustment techniques, notably with the aim to explaining why plain cost adjustments, i.e. without inclusion of a risk/profit element associated with productive expenditure, often produce flawed comparability adjustments (e.g. in cases where R&D expenditures strongly vary between the comparables and the taxpayer).

Paragraphs 3.56-3.58 and 3.60/3.61: Arm's length range + paragraph 3.78: Multiple year data (statistical tools)

The reasons why any transfer pricing method will normally produce a range of comparable data has been abundantly explained in the existing TPG. This reality should not be diluted where all observations are equally reliable and the full range should be used in such cases to check the appropriateness of the taxpayer's transfer pricing policy. However, where - despite accurate adjustments - the observations are not all equally reliable, it may be necessary to reduce the size of the range and use, for example, an inter-quartile range in order to mitigate potential errors. We would however hesitate to call this a statistical method because the total number of valid observations is most of the time rather low.

While it may not be fully satisfactory to automatically adjust to the lowest or the highest point of an agreed range where no point within the range can be identified as best reflecting the facts and circumstances of the particular controlled transaction, we do not support the use of statistical tools. If an agreement can be reached on what should be the size of the range (e.g. an inter-quartile range), why depart from the practical solution that consists in referring either to the lowest or the highest point of the range where the reported results are outside such range?

The arm's length principle should not become a matter of statistical probability, thus giving the impression that the result is scientifically correct although it is well-known that transfer pricing is not an exact science. While ranges should be used as plausibility tests, the simple or weighted average, the median and also the most frequent value (mode) within such ranges are likely to produce arbitrary results and their use should not be endorsed.

Paragraphs 3.57 and 3.58 should not give the impression that the use of more than one transfer pricing method is the rule. It should be clearly stated that there is a primary method, i.e. the one used by the taxpayer, and that – depending on the difficulties deriving from the comparability analysis - recourse to a corroborating method may become unavoidable. However, it is not correct to say that a range “may also result” (or results) when more than one method is applied (see also last sentence in paragraph 2.10); in practice each method will normally produce its own range.

Paragraphs 3.69 and 3.70: Timing of collection

While we understand that tax authorities have often no alternative but to apply the arm's length outcome-testing approach, we think that this approach raises the same sort of concerns as the ex post profit split approach and the ex post use of "more reliable" comparables (see paragraph 3.3). A clear reservation should be introduced in these paragraphs against the use of hindsight. Moreover, one should keep in mind that independent third parties normally determine their prices in advance.

Annex II to Chapter II, Part III (Illustration 1; paragraph 3)

We think that if case 2 should really show a situation between related parties (important gross margin) and case 1 a situation between unrelated parties (lower gross margin) the first conclusion would be that the related party reported excessive profit; this should be clearly said because Illustration 2 shows the reverse situation. The use of the TNMM (net operating margin or Berry Ratio) would obviously in both illustrations (1 and 2) mitigate, if not eliminate, the risk of error.

Annex III to Chapter II, part III (paragraph 8; second bullet point)

It would help the reader if an explanation was given on the reason why "a lending rate may be considered" when Payables > Receivables + Inventory.
