UNITED STATES COUNCIL FOR INTERNATIONAL BUSINESS

February 21, 2017

VIA EMAIL

Global Tax Platform

GlobalTaxPlatform@worldbank.org

Re: USCIB Comment Letter on the Discussion Draft: A Toolkit for Addressing Difficulties in Accessing Comparables Data for Transfer Pricing Analysis

For the attention of the members of the Global Tax Platform,

USCIB[1] appreciates the opportunity to comment on the draft toolkit (hereinafter "toolkit" or "discussion draft"). In our view, an open comment process is an important part of developing helpful guidance that will meet the needs of both tax administrators and taxpayers.

Our comment includes a letter and an attachment. The letter sets out our overarching comments. The attachment provides detailed comments on particular paragraphs.

As a preliminary matter, USCIB recognizes that the drafters face a difficult balancing act. The toolkit is intended to provide guidance to developing countries that may be in very different stages of economic development. The toolkit therefore needs to focus on general guidance, as opposed to detailed prescriptions. In our view, the toolkit strikes an appropriate balance between these two concerns. It may also be possible to continue to adjust this balance by adding examples to the case studies as countries and taxpayers gain experience with the toolkit and developing countries increase their tax administration capacity.

The toolkit also takes a pragmatic approach to resolving transfer pricing questions, which USCIB believes is very important. This pragmatic approach includes, for example, the need to take into account the availability of comparables in choosing the most appropriate transfer pricing method. The attachment points out and supports other instances of this pragmatic approach.

USCIB also believes it is important to clarify the relationship between the OECD Transfer Pricing Guidelines (hereinafter "OECD TPGs" or "guidelines"), the UN Practical Manual on Transfer Pricing for Developing Countries (hereinafter "UN TP Manual" or "manual") and the toolkit. If there is a conflict between the guidelines or the manual and the toolkit, then the guidelines or manual should control and the toolkit should explicitly state that result. As a product of the Platform of Collaboration on Tax, the toolkit does not have the same status as either the guidelines or the manual. The OECD TPGs are the

[1] USCIB promotes open markets, competitiveness and innovation, sustainable development and corporate responsibility, supported by international engagement and prudent regulation. Its members include top U.S.-based global companies and professional services firms from every sector of our economy, with operations in every region of the world. With a unique global network encompassing leading international business organizations, USCIB provides business views to policy makers and regulatory authorities worldwide, and works to facilitate international trade and investment.

product of negotiations among governments acting in their official capacity. While the guidelines represent "soft law", the parties negotiating the guidelines have officially endorsed the guidelines. This is not true for the toolkit. The UN's Committee of Experts on International Cooperation in Tax Matters is not an official governmental body and the members of the Committee do not participate in their official governmental capacity, so the manual is likely even "softer law" than the OECD TPGs. The drafters of the manual, however, have sought consistency with the OECD TPGs, so to the extent possible the guidelines and the manual should be interpreted consistently. In any event, the toolkit should not supersede these documents and the toolkit should make that clear.

USCIB is concerned that the toolkit overemphasizes the application of substance over form principles and may lead to recharacterization in inappropriate cases. While accurate delineation of the transaction is a part of every transfer pricing analysis, contracts and agreements are important factors in that analysis. Adjustments may be made that do not result in changing the character of the entire transaction. Recharacterization of the entire transaction is inherently subjective and will likely result in double taxation and disputes. Increasing double taxation and disputes will result in a drag on foreign direct investment. USCIB is particularly concerned that all three case studies presented in the toolkit show transactions where recharacterization occurs. In our experience this is not representative. A better approach to the examples might be to show some transactions that are respected without adjustment, some that are respected with adjustment and some in which the transaction is recharacterized.

USCIB is also concerned about the role of and description of profit splits in the toolkit. The toolkit on multiple occasions states that the profit split method is a method that may be applied in the absence of comparables. This is misleading, inconsistent with OECD guidance, and may lead to tax authorities defaulting to the profit split method when its use is not appropriate.

The OECD's recent discussion draft on profit splits discussed the use of the profit split method when comparables are difficult to find.

> A lack of comparables alone is insufficient to warrant the use of a transactional profit split of actual profits under the arm's length principle. In cases where the accurate delineation of the actual transaction indicates that one of the parties to the transaction assumes only limited risks, but reliable comparables data is scarce, it is likely that a more reliable arm's length outcome can be reached through the adjustment (under Step 8 of a typical process for performing a comparability analysis in paragraph 3.4) and interpretation (under Step 9 of a typical process for performing a comparability analysis in paragraph 3.4) of inexact comparables data rather than through the inappropriate application of the transactional profit split method. Using a transactional profit split of actual profits in such a case would result in a fundamentally different economic outcome to the one supported by the accurate delineation of the actual transaction.[2]

The quoted language essentially makes the point that it is more important to use the correct method. Inexact comparables may be adjusted, but using an improper method assigns profits to the incorrect party.

In addition, even in the case in which the transactional profit split method is the best method and should be applied, it is likely that comparables will be necessary to its proper application. Under the

[2] OECD Public Discussion Draft BEPS Actions 8 -10 Revised Guidance on Profit Splits, paragraph 18.

transactional profit split method, the first step is to assign routine returns to the relevant party based on the application of one of the one-sided methods. Only the residual profit is then split between the parties to the transaction. Thus, comparables are usually needed to properly apply the profit split method. In addition, comparables should be considered in determining the appropriate methodology used to split the profits between the parties to the transaction.

The transactional profit split method may be the most appropriate method when both parties to the transaction make unique and valuable contributions. The interpretation of unique and valuable contributions in the toolkit[3] introduces the new notion of "valuable scarce contributions". It is unclear what the introduction of scarcity adds to the existing unique **and** valuable contributions. Some contributions may be scarce (e.g. rare earth minerals) but not unique and are capable of being valued without reference to the profit split method.

Finally, highly-integrated operations do not mean that a transactional profit split is the best method.[4] First, the profit split method is transactional, so parts of the value chain that are not participants in the relevant transaction are not relevant to determining the division of income between the parties to that transaction. Second, high-integration does not mean that the contributions are unique and valuable. For many businesses, high integration is a requirement to remain competitive. Within an integrated business some entities will perform routine functions for which comparables will be available. Thus, high-integration is not necessarily an indicator that the transactional profit split method is the most appropriate method.

Sincerely,

William J. Sample
Chair, Taxation Committee
United States Council for International Business (USCIB)

[3] Toolkit, page 61.
[4] OECD/G20 Base Erosion and Profit Shifting Project, Aligning Transfer Pricing Outcomes with Value Creation, Actions 8-10: 2015 Final Reports, page 60 (hereinafter "Actions 8-10 Final Reports") provides that "additional guidance will be provided on when significant integration of business operations may lead to the conclusion that a transactional profit split is the most appropriate method." This implies that not all cases of significant integration should result in the use of the transactional profit split method. Including significant integration as a factor without that further guidance could be misleading and could result in tax authorities routinely applying the profit split method, in many cases inappropriately. This is especially problematic given that the one factor that is mentioned in the Actions 8-10 Final Reports as a possible basis for distinction between cases in which profit split may be appropriate vs. those is which it is not (sequential vs. parallel integration) has been found to be unhelpful outside of the area of global trading of financial assets.

Attachment

1. Page 5, second paragraph, the discussion of transfer pricing as a "necessary feature" of commercial activities should mention that determining a transfer price is a legal requirement for enterprises engaged in cross-border activities with related parties. It should also note that in many countries a history of local country non-compliance has led to countries relying on foreign multi-national enterprises for a disproportionate share of their revenue.

2. Page 6, first paragraph, over emphasizes the need to recharacterize transactions. Although recharacterization is sometimes appropriate, consistent with the OECD guidelines[5], disregarding or recharacterizing the transaction should be limited to exceptional circumstances. Even if the transfer price should be adjusted, the starting point should be the transaction and comparables, even comparables requiring adjustments should not be rejected prematurely.

3. Pages 6 and 7, carryover paragraph, the toolkit points out that perfect comparables may only rarely be available, nevertheless, "commonly the data that is available will still allow a reasonably reliable analysis to be performed and a satisfactory approximation of an arm's length outcome to be determined." USCIB agrees with this and believes that this point should be emphasized and moved to the initial discussion (first paragraph of page 6).

4. Page 9, section 2.2.1, the second bullet refers to the "wider generation of value by the multinational enterprise". Is this intended to require a value chain analysis is all cases? USCIB believes a value chain analysis is not required in all cases and that the toolkit should make that clear.

5. Page 13, Box 2 provides an example of the application of the arm's length principle to a sugar producer. The example might be more helpful if there were additional facts concerning how market prices are to be determined. Is a spot rate used? A weighted or unweighted average?

6. Page 14, section 2.4.1 recommends taking practical considerations into account in determining the most appropriate method. USCIB commends this recommendation.

7. Page 17, section 2.4.1(e) concerning the transactional profit split method provides that a transactional profit split method may be the most appropriate method where the business operations are highly integrated. USCIB believes this does not represent the most current thinking on the profit split method and therefore this bullet should be deleted. If the relevance of integration is still being debated at the policy level, then the toolkit should not foreclose that discussion.

[5] Actions 8-10 Final Reports, page 14.

8. Page 18, section 2.4.1 concerns the application of the most appropriate method. The paragraph contains a sentence that reads as follows: "Moreover, once a method has been determined to be the most appropriate given the nature of the transaction, it should not be easily dismissed due to 'imperfect' comparables." This is an extremely important point and should be emphasized more strongly.

9. Page 15, Cost Plus Method provides that "the determination of the appropriate cost base will often be of greater importance than the amount of the mark-up, particularly where the activities concerned are considered to be relatively low value-added." Even at low margins, the differences in markups can produce significant differences in taxable income if the PLI base is large. While both the cost base and the mark-up are important to the determination of the appropriate transfer price, the cost base can be more difficult and time-consuming to determine than the mark-up, particularly in the case of pass-through costs.

10. Page 16, second paragraph provides: for a "reseller …there is normally a strong correlation… between the level of sales and …profitability." This raises two points. First, the size of the business is an important factor in selecting comparables, with comparables from businesses of comparable size being more reliable. Second, compensating the distributor for the functions it performs using operating expenses as the PLI may be more reliable, but the return on sales is often used because the comparables may classify some costs as COGS rather than as operating expenses relative to the tested party (and vice versa) and the differences cannot be reliably identified.

11. Page 17 (middle of the page): The transactional profit split method is presented as a method that can be applied in the absence of comparables. As we point out in our cover letter, the toolkit should note, however, that under the OECD Guidelines the profit split method does use comparables to compensate the parties for routine contributions following one of the traditional transaction methods or a transactional net margin method. Comparables should also be considered in determining the appropriate methodology used to split the residual profits between the parties to the transaction.

12. Page 20, Box 3: Scenario 1 mentions "a Cost Plus analogue, but applied at the net margin level." A mark-up on full costs is a commonly used transfer pricing method, so USCIB supports an example illustrating the use of this method. However, the reference to the parenthetical quoted above might be confusing to the reader because page 16 specifically instructs the reader not to confuse a (full) cost plus with the Cost Plus Method.

13. Page 20, Box 3: The choice of the method and PLI in scenarios 1 and 2 seems to be artificial. It might help to put some context around these choices, for example, by

bringing the last two bullets in the Box into the description of the scenarios or by moving the caveat in the footnote to the beginning of Box 3. Otherwise this example might be easily misread as providing that in a particular case either option would be acceptable. The operating margins should be more realistic. Using unrealistic margins in examples (even with caveats that the illustrations and case studies used in the toolkit are for illustrative purposes only) may create unrealistic expectations of high returns when those expectations would be misguided.

14. Page 21, section 2.4.3 seems to be dismissing one-sided methods too forcefully. If an enterprise assumes economically significant risks, including those associated with a unique and valuable intangible, a one-sided method may still be appropriate, but the other party may be the tested party. The profit-split method should only be used if both parties make unique and valuable contributions to the transaction, including especially the use of unique and valuable intangibles. All businesses take risks; so, the presence of risk does not mean that comparables are unavailable and returns may be routine. Taking on even significant risks is no guarantee of non-routine returns - most businesses fail.

15. Page 21, section 2.4.4 again seems to be driving too forcefully in favor of the profit split, even though it acknowledges no hierarchy of methods.

16. Page 21, section 2.4.4, provides that "a CUP or a one-sided method…" this suggests that a CUP is not a one-sided method, which of course it is. A better formulation would be "a CUP or other one-sided method." USCIB believes the reference to "highly integrated" should be deleted.

    As pointed out above,[6] Actions 8-10 Final Reports indicates that "additional guidance will be provided on when significant integration of business operations may lead to the conclusion that a transactional profit split is the most appropriate method." Actions 8-10 Final Reports mentioned a possible distinction between sequential and parallel integration as a basis for distinguishing between cases in which a transactional profit split may be appropriate (parallel integration) and not appropriate (sequential integration). The recent discussion draft on profit splits solicited comments on the helpfulness of this distinction. As USCIB understands that the current view is that this possible basis of distinction has not proved helpful. Therefore, there is no current guidance on when integration should be taken into account. In USCIB's view, in the absence of any guidance on when integration should be taken into account, this reference to "highly integrated" should be deleted. High levels of integration are not an indicator of either lack of comparables or non-routine returns and should therefore, in the absence of detailed guidance, not be used to justify the use of profit splits.

[6] Footnote, 4.

USCIB suggests that the second paragraph in section 2.4.4 be deleted. This does not add anything to the guidance provided by the toolkit and could be misconstrued as suggesting that the desire to reach a particular profit allocation outcome could drive the selection of the most appropriate method.

17. Page 22, section 3.2 states that "any source of information should be acceptable, as long as leads to reliable financial and business information for the transfer pricing analysis." USCIB strongly supports this statement (with the caveat of our previously stated objection to secret comparables). This section also states that there is no hierarchy between internal and external comparables, but then quotes the OECD Guidelines that "internal comparables may have a more direct and closer relationship to the transaction under review". This implies that internal comparables, when available, may be better than external comparables. Similarly, internal consistency across similar affiliates is also a strong indicator that the transfer pricing method has been appropriately chosen and applied and the toolkit could address this.

18. In several places, the draft mentions the "supplementary study into mineral product pricing" (e.g., bottom of p.24), but we cannot find it in the toolkit.

19. Page 26, Box 4: It might be helpful to note in this example that the return on assets might be preferable in this case and that the return on total cost might be questionable if the costs of ingredients for chocolate and granola bars are different. Either of these methods would be preferable to an inappropriate application of the profit split method.

20. Page 27, Box 5 states that Company A posted an operating loss in the relevant period. The relevance of this information is unclear. It does not appear to be useful in the comparability analysis because there is no discussion on the treatment of losses in the selection of 33 potential comparables. It may be that the existence of the loss was relevant in determining whether Company A was selected for audit. It seems that the example is illustrating a case when control of risk and therefore return to risk is with Company B. The implication being that any losses should be borne by Company B and Company A should in all cases have a routine positive return on its low risk business. If this is the case, then perhaps that should be stated. It might also be useful to show a second year, when the overall business is profitable and that using the same transfer pricing method to determine the return to Company A would be appropriate in that case.

21. Page 27, the paragraph below Box 5 suggests that foreign comparables can be considered when local comparables are scarce or unavailable. USCIB strongly supports this recommendation.

22. Page 28, Box 6 mentions “economic conditions” that are similar to those in Country X. The term “economic conditions” needs to be elaborated further: e,g, what makes Taiwan different from Japan?

23. Page 29, Box 7 contains a broad helpful definition of market, where the market is considered a key comparability factor.

24. Page 30, Box 8 starts with the discussion of how tax authorities approach the taxpayer’s benchmarks. But then at the end it states that Colombia always does its own functional analysis. This seems to be conflating functional analysis and benchmarking where they can be separate: a tax authority can perform its own functional analysis and then use the taxpayer’s benchmarks if the results of the functional analysis are consistent.

25. Page 31, (2.4.1.1), contains paragraphs concerning the use of information in the hands of the tax authority and seems to endorse the use of secret comparables. USCIB strongly opposes the use of secret comparables. The last sentence of the first paragraph should be the first sentence. That is, the caution in the OECD guidelines against the use of secret comparables should be emphasized and a reference to the caution in the guidelines should be included in the toolkit.[7] The UN TP Manual, while not containing as strong a statement against the use of secret comparables, does recommend against the imposition of penalties on taxpayers for failing to submit data to which they did not have access.[8] This caution should also be included in the toolkit.

26. Page 34, Box 10 states that “the audit team had a number of options…” but does not provide guidance as to which factors might be relevant to evaluate and select the best option.

27. Page 34, the paragraph below Box 10 recognizes that an independent minority shareholder may mitigate risks of non-arm’s length practices among related entities. USCIB supports this pragmatic approach to independence requirements.

28. Page 38, section 2.5.2.1 talks about working capital adjustments to adjust for differences in functions, including holding inventories. The paragraph needs to have a stronger statement regarding the need to compare functions because holding (or not) of inventory might indicate that one entity is a distributor whereas the other one is a sales agent, in which case their revenues will be very different and no amount of inventory adjustment will fix this.

[7] OECD Transfer Pricing Guidelines, paragraph 3.36, and
[8] UN TP Manual section 7.4.3.4.

29. Page 38, section 2.5.3 discusses solutions to the differences in accounting treatment, including multiple year data. This is an important point, with various ways of calculating the results. It would be helpful if this discussion could be expanded.

30. Page 39, section 2.5.4.1 discusses the reliability of adjustments. The drafters of the toolkit should recommend against "black box" adjustments where the adjustment is unlikely to withstand challenge.

31. Page 42, Figure 1. The example would be improved by the addition of cautionary statements that freight rates can vary by product.

32. Page 43, section 2.5.5.1 notes that because of the lack of local comparables foreign data is extensively used, but makes no recommendation concerning whether that is appropriate and recommends further study. Although further study would be welcome, in the interim the toolkit should emphasize that: the reliability of information is always relative; taxpayers and tax administration must use the information that is available; a determination of which information is the best available or most appropriate must be made as transfer prices must be determined.

33. Page 45, first paragraph, last sentence: "In situations where ***the companies operate in a region*** where not only the economic circumstances, but also the underlying credit risk and interest rates are significantly different from the tested party ***and the comparables***, adjustments for those differences should be considered as well." (emphasis added). What is the relationship between the companies in a region and the comparables?

34. Page 45, second paragraph (the WCA) correctly states that following the second step, the comparable's revenue and operating profit will increase (relative to the result in step 1). The overall result (i.e., after steps 1 and 2), however, depends on the ratio of accounts receivable for the comparable and the tested party and on which interest rate (A or B) is higher.

35. Page 45, Box 17 needs to define the "geographic market adjustments." For example, for Mexico, the benchmark based on U.S. comparables can be unreliable if labor/capital intensity of the Mexican operations are different from the U.S. operations, and a return on capital benchmark is used.

36. Page 46, section 2.6 includes a statement that it is common to determine a range of results and accept results that fall within that range. USCIB strongly supports the use of arm's length ranges and the acceptance of results falling within those ranges.

37. Bottom of page 46, the toolkit should define the meaning of the "relatively narrow" range.

38. Top of page 47, paragraph 2.6.1, provides: "where the range of results from a set of comparables is wide… countries may wish to consider introducing a provision … that the highest point in a range may not exceed a percentage (say 25 percent) of the lowest point in the range. Where this cap is exceeded, a statistical approach may be stipulated." The proposed solution to problem of a wide range of comparables may produce results at odds with the arm's length standard. If the range is wide, perhaps as an initial matter, the tax authorities should take a second look at the functional analysis and determine whether the range can be narrowed by removing inexact comparables. Different approaches to introducing a ceiling or floor on a range can produce very different results. One could go up 25% from the lower point, or down 25% from the upper point which would produce very difference results. Using the range in Box 18, 1.2% x (1+25%) = 1.5% while 14.7% x (1-25%) = 11%. Is this what is intended: two ranges, 1.2% - 1.5% and 11% - 14.7%? If tax authorities are going to adopt a ceiling or floor should they be required to apply those rules consistently regardless of whether the tax authorities would prefer a ceiling or floor in a particular case?

39. Page 47, section 2.6.3 suggests using a lower point in the arm's length range for an entity with limited functions). This approach may not achieve arm's length results. While in general limited functions may correspond with lower compensation that is not always the case. There may be other reasons for the lower returns including that the lower end of the range may include companies that are simply less efficient than their competitors.

40. Page 48, section 2.6.3.1 the toolkit discusses the use of financial ratios. The paragraph suggests that financial ratios "can be used to help distinguish between results from transactions with differing degrees of comparability and potentially to eliminate those with a lower degree of comparability from the potential comparable set." Because the application of financial ratios would help narrow the range and eliminate inexact comparables, this step should be taken before applying a ceiling or floor and applying a statistical approach. Therefore, it might be appropriate to move this paragraph or at least cross-reference the need to apply financial ratios first. The paragraph should also elaborate on (i) how to apply the diagnostic ratios, (ii) what the difference is between diagnostic ratios and screening that was explained in Box 7 (point #9), and (iii) what is meant by "refine the arm's length range" (i.e., does this mean certain comparables should be removed or does this mean they should be adjusted?).

41. Page 49, Box 20 provides an example of a build-up approach. The start of the example suggests that only Australia applies a build-up approach. It would be helpful to know if other countries use this approach. USCIB supports pragmatic solutions to transfer pricing issues. The build-up approach may provide such a pragmatic solution in appropriate cases.

42. Page 51, section 3.1 the final two paragraphs, as written, cast doubt on the reliability of comparability analyses – in particular the language that reads "it is only rarely that data is available to provide a well-defined measure of the arm's length price or result" -- and seem to sanction departures from the comparables. This should be toned down. While it is true, that transfer pricing is an art, not a science, comparables are essential to implementing the arm's length standard and the toolkit should not take too negative a tone on the usefulness of comparables. The choice of method and evaluation of comparables is a relative choice and not choosing is not an option. Taxpayers and tax authorities often need to use the best available comparables as a better option than using a different method.

43. Page 53, section 3.3 the contains the following sentence: "Testing the arm's length nature of a transaction can be particularly ***useful*** where sufficiently reliable comparables cannot be found." (Emphasis added.) The meaning of this sentence is unclear. It may be attempting to say that the conditions of the transaction must be similar to the conditions negotiated between independent parties. This is not consistent with the OECD Transfer Pricing Guidelines, which provide that "the mere fact that the transaction may not be seen between independent parties does not mean that it should not be recognized."[9]

44. Page 53, section 3.3.1 discusses the application of the a "benefits" test to intangibles. While section 6.6 of the OECD TPGs[10] provides a definition of intangibles that looks to whether the "use or transfer (of the intangible) would be compensated had it occurred in a transaction between independent parties in comparable circumstances", (parenthetical added) the modification of the definition was primarily focused on requiring the taxpayer to pay for something of value, rather than disallowing a payment. As USCIB understands this revision, the primary objective was ensuring taxpayers paid for goodwill. The new "benefits" test may create a real conflict between countries that require payments for goodwill and other countries that insist there is no benefit from the use of the goodwill, or at least no demonstrable benefit. Further, a payment may be required to avoid infringing on intellectual property of a third party. If the payor has an infringing product or service it developed on its own, it does not "need" the third party's IP, but it must pay for that IP to avoid infringing on the other party's IP. In our view, the benefits test should be deleted pending further work on the meaning of such a test in the context of intangibles.

45. Page 54, section 3.4 introduces the concepts of safe harbors. USCIB strongly supports the use of appropriate safe harbors. We note that the specific limitations that define the scope of the safe harbors are extremely important and care should

[9] Actions 8 – 10 Final Report, page 14 and paragraph 1.122.
[10] USCIB understands that the updated UN TP Manual will contain a similar definition of "intangibles", although the updated manual is not finalized.

be taken in crafting those definitions. Safe harbors help taxpayers (and tax authorities) achieve certainty. However, if the scope of the safe harbors is not carefully defined, then tax authorities may be dissatisfied with the outcomes, potentially undercutting certainty for taxpayers.

46. Middle of page 56, section 3.4.1 describes some of the pitfalls of safe harbors. Many of these pitfalls could be avoided if the safe harbors are set bilaterally or among a regional group. This could be highlighted and a reference to the later discussion on the merits of regional international cooperation could be added here.

47. Page 59, section 3.4.2:

    The first bullet should also be part of section 3.4.1 (TP safe harbor).
    The benchmarking process mentioned in the second bullet will need to be very detailed. Otherwise a regional search can produce very large sets, which might not provide the sort of narrow range that a safe harbor would like to achieve.
    It is not clear what is intended by the fourth bullet. Is this intended to provide for self-adjustment?

48. Page 59, section 3.4.3 provides a brief description of prescriptive rules. Some additional examples (other than the Brazilian case presented on the next page) would be helpful here. Also, prescriptive rules generally are not consistent with the arm's length method because they are prescriptive and do not take into account the facts of the particular case. The toolkit should note that prescriptive rules may, therefore, be inconsistent with treaty obligations, if the country has agreed to apply the arm's length standard in its income tax treaties.

49. Page 61, section 3.5, the second full paragraph overlooks the residual analyses of the profit split in which case the comparables may be required and that comparables are relevant to the choice of method used to split the profit. As we have pointed out above, at this point high-integration is not an appropriate standard for determining whether the transactional profit split ought to be applied and the lack of comparables is not an appropriate basis for choosing the profit split method.

50. Page 62, section 3.6, with regard to large capital assets, the draft needs to emphasize that the value should be arm's length.

51. Page 62, section 3.6 concerning valuation techniques provides: "***In addition to the valuation report***, an analysis based on such techniques should therefore also consider the basis of the ***underlying assumptions***…" (emphasis added). The valuation report itself should consider the underlying assumptions.

52. Page 63, section 3.7 discusses anti-avoidance measures. The first paragraph of that section states that "the topic of anti-avoidance measures is extremely broad, and

thus beyond the scope of this toolkit". If that is the case, then section 3.7 ought to be deleted. More specifically, this section suggests capping royalty deductions by the ratio of royalties payable to EBITDA. This suggestion is not really appropriate for a toolkit aimed at assessing difficulties in comparables data for transfer pricing analysis and should be deleted. Although this concept is somewhat similar to the limitation of the interest deduction developed as part of the BEPS project, any cap with respect to royalties would need to take into account different considerations. Intangibles are not the same as monetary capital. While in some senses money is fungible, intangibles are not. Different intangibles may support different parts of a business and some businesses may be much more intangible intensive than others. Further, the interest limitations were developed after a consultative process and the 2015 Final Report, which was not comprehensive, ran over 100 pages. If a cap approach is to be developed for royalties, a thorough analysis of the issues and approaches should be developed. In the interim this paragraph should be deleted. Finally, with respect to section 3.7, the discussion of CFC rules is too cursory and should be deleted.

53. Page 65, section 4.1, the fourth paragraph discusses some possible approaches in light of the lack of data. In our view, three of the options – benefits tests, profit splits, and protective measures – do not really respond to the lack of data. If an intangible were found to produce a benefit, then the data issue is not addressed. As we have noted at several points in this comment letter, profits splits routinely require the use of comparables. Protective measures are not sufficiently identified to provide solutions.

54. The last paragraph on page 65 should mention ranges.

55. Page 66, section 4.2.2, refers to information contained in tax returns that is normally not useable because it is confidential and therefore cannot be disclosed to another taxpayer. USCIB strongly supports maintaining taxpayer confidentiality and opposes the use of secret comparables. The OECD Transfer Pricing Guidelines explicitly state that tax authorities should disclose such data within the limits of domestic confidentiality rules. A cross-reference to this OECD guidance should be included.

56. Page 67, section 4.2.3.3 overlooks (again) the fact that most profit splits will be residual profit splits. It is important to note that comparables will be required to determine returns to routine functions and that profit splits are only appropriate for the non-routine returns.

57. Page 69, section 4.3.9 recommends "considering the feasibility and the advantages and disadvantages of measures designed to protect the tax bases of developing countries in cases where there is both a systemic high risk of tax loss and an inability to apply transfer pricing measures due to lack of information or gaps in capacity." A possible royalties cap is mentioned in this context. Countries are of course free to

take steps that protect their tax bases especially in the context of systemic high risk. Countries should, however, also take care to implement any such measures in ways that do not discourage investment and development and therefore ought to engage in a consultative process prior to adopting new rules. As discussed in more detail above, the royalties cap would raise significant policy and design issues; because those issues have not been considered, the reference to a royalties cap should be deleted.

58. Unnumbered page 72, Case study 1, the last bullet provides that A Co: "effectively manages inventory, delivery shortfalls, and excesses." More detail is required to determine how this is the case, if B Co buys the entire production from A Co under the off-take agreement.

    Unnumbered page 74, Case study 1, carryover paragraph recharacterizes the transaction and treats the risks that were contractually allocated to A as allocated to B. This decision should be explained in more detail. The last paragraph of the case study should also contain additional explanation, in particular as to why the TNMM method was selected. Further, the example states the analysis focuses on the amount of the costs, since this will have a greater influence on the price. As pointed out above, the mark-up may be equally important, although the costs may be harder to determine. The tax auditor selects B Co as the tested party. "The transactional net margin method (TNMM) ***with (full) costs as the profit level indicator*** was selected as the most appropriate transfer pricing method for the case. In this regard, much of the analysis focuses on determining ***the appropriate cost base*** in B Co since this will have a greater influence on the total transfer price than the markup." (Emphasis added.) It is not clear why B Co's appropriate cost base is in question since the PLI is based on full costs.

    The drafters of the toolkit should consider including a discussion of pass-through costs here. Unless the tax authorities start with a proper functional analysis, pass-through costs can distort the determination of the arm's length price. For example, if a foreign principal directs the amount, make-up and direction of the local distributor's marketing, the foreign principal would control and bear the marketing risk. The marketing costs are pass-through costs and are taken into account in setting the transaction price from principal to distributor. Unless the fact that marketing risk is borne by the foreign principal (which is supported by the functional analysis) is properly taken into account when screening for comparables, the set of comparables produced may not be reflective of the function and risk profile of the local distributor. That is, looking only at the marketing costs, might lead to the conclusion that the distributor is bearing the marketing risk, when that is not the case for pass-through costs. The analysis cannot, therefore, start with costs, but must start with the functional analysis, so only relevant comparables will be selected.

59. Case study 1 needs to clarify whether or not B Co bears the risk of price fluctuation. B Co buys from A Co at one price, and resells to customers at another. Case study 1

seems to imply that the price risk is nonexistent because B Co sells to customers "immediately" but it would help if this were stated explicitly.

60. Unnumbered page 75, Case study 2, first paragraph under Part B, the last line uses the word "recharged" to XYZ (S) is this correct?

61. Unnumbered page 76, Case study 2, the paragraphs on delineating the actual transaction indicate that the transaction is recharacterized. The example should explain the basis for this recharacterization.

62. Case study 3, first page, Part B, last paragraph, third line: "A Co pays the cost of refining each bar…" Should it be that B Co pays the cost since B Co has the refinery?

63. Case study 3, end of Part B, transfer pricing method: "Refined gold is a highly commoditized product with a highly liquid international market… [G]old sales are judged to be a routine function and should, therefore, be routinely remunerated using the transactional net margin method (TNMM) with sales as the profit level indicator…" Earlier in the case study, however, B Co is said to bear the risk of price fluctuation. The case study dismisses this risk by saying that B Co on-sells "as quickly as possible." How quickly is quickly? Gold refining is not as simple or fast as the case study seems to suggest. For example, EDI Refining states as follows: "Once the gold is drawn from the earth, it's still not ready for the market. It must be refined and smelted and crafted. This is obviously not something that can be done easily and quickly. It takes time and care. If, at any point during this process, a mistake is made, then you can expect the price of gold to drop accordingly. This is further complicated by the fact that gold is an extremely soft metal that often requires special care; a hasty or unexamined refining process can cause issues." http://www.edirefining.com/blog/how-mining-and-refining-can-change-the-price-of-gold/ With this in mind, a profit split between mining and refining might be appropriate.

64. Case study 3, Part C appears to be incomplete.

65. Appendix 1 contains a lengthy questionnaire covering functional analysis. It would be useful to suggest that as an initial matter, the tax authorities look at the material they already have in their possession, particularly the master file and local file, to enable them to gain an understanding of the taxpayer's business and the transactions occurring in their jurisdiction before deciding whether and how that information needs to be supplemented. It would also be helpful if the draft elaborated on how to use the information collected through the questionnaires.

    Perhaps the risk questionnaire can be modified so that it focuses on identifying the economically significant risks first and then go through the more generic checklist.

With respect to intangibles, the questionnaire does not ask questions that go to the issue of control, perhaps such questions could be added.

66. Appendix 7 sets forth possible independence criteria. The appendix refers to “3 ‘collective’ types” that are excluded without defining what these excluded collective types are.

67. Appendix 7, second page, Indicator D: If “D” companies are not selected in the search set, this indicator in particular will eliminate privately held companies. So, unless there is intent to eliminate privately held companies, in order to include them in the set of potential comparables, one would need check the second square from the bottom of the **BvD Independence Indicator** tab whose function is to *“Add companies for which all shareholders belong to categories "one or more individuals or families" or "Employees/Managers/Directors" as well as companies for which all shareholders with a stake greater than 25% belong to categories "one or more individuals or families" or "Employees/Managers/Directors."*

68. Appendix 8, first page, third bullet from the bottom provides: “To have a good understanding of the outcome of the benchmark, a rough data dump within the database can be made. This number should be in line with the final outcome of the benchmark. If there are big deviations, leading to doubts as to the reliability of the benchmark, this should be discussed with the taxpayer.”

    USCIB has several concerns with the data dump:

    - How “rough” should the data dump be? (i.e., at which point in the screening is the set sufficiently “rough”?
    - The benchmark from the final set of selected comparables might not be “in line” with the benchmark from the rough data dump if the rough set includes poor comparables. The paragraph suggests that the selected set would be questionable if the benchmarks don’t match, but it can be just the opposite, and the final set can be reliable if the rough set contains a lot of noise.
    - Should the rough set should include or exclude loss companies?
    - Relying on a rough data dump seems inconsistent with paragraph 1.40 of the OECD Transfer Pricing Guidelines, which provides: “Therefore, in no event can unadjusted industry average returns themselves establish arm’s length prices.”
    - The last bullet in Appendix 8 may be inconsistent with the OECD Transfer Pricing Guidelines. The discussion provides: “Comparability adjustments and diagnostic ratios: These adjustments should only be made to increase the comparability and the reliability of the data, not to create comparability. Caution is advised when using adjustments or diagnostic ratios.” Paragraph 1.40 of the OECD Transfer Pricing Guidelines provides: “comparability adjustments must be made, where possible, to improve the reliability of the comparison.”

69. Appendix 8, first page, last bullet concerning loss-making comparables provides that "normally, loss-making comparables are refused…" which is true. The draft should make a stronger case in support of the loss-making comparables whose use can be quite appropriate if the industry as a whole has experienced a downturn lasting several years. The decision as to whether to keep or reject the loss comparables should be made after the state of the industry has been reviewed.

70. Appendix 8, second page concerning the number of comparables provides: "If there is a small number of comparables, this may have a strong influence on the comparability and the use of a statistical interquartile range." The meaning of this sentence is unclear.

71. Appendix 9 should point out that the calculation of the working capital adjustment depends on the PLI base. In the current Appendix 9 all ratios are calculated relative to sales, which is correct for a sales-based PLI such as the return on sales. For a PLI based on total cost ("TC") or on operating expenses (i.e., Berry ratio), the corresponding base should be used to calculate AR, AP, and Inv adjustments: e.g., AAR/TC or AAR/OpEx. This is the approach taken by APMA in the APA template file.

72. Appendix 9, first page, last paragraph needs to be revised because, as written, it is confusing.

    The paragraph states that "In the case where the tested party is holding higher inventory levels, the comparables' adjusted inventory will be positive, operating expenses will be reduced, and the comparables' operating income will be increased to reflect the comparables' cost savings from holding fewer inventories."

    Comments:
    - The COGS reflect inventory adjustment, not OpEx.
    - The use of the future tense "will be" is confusing: *will be* after adjustment?

73. Appendix 9, second page, last line: the sign in the formula should be "+".

74. Appendix 10, second page, second bullet under "Some observations," in the fourth line the phrase "short-term" should be added so the sentence would read as follows: "In most cases a ***short-term*** commercial loan rate will be appropriate."

75. Appendix 13 contains examples on country risk adjustments. Example 1 involves a tested party in country A and a comparable in country B. Country risk in Country A is higher than in Country B. The example suggests that the return on assets of tested party should be increased by 4%, which is the difference in long-term government bond yield between Country A and Country B.

It is not clear why this is an appropriate methodology to adjust for country specific risk. There are different types of country specific risks and different methodologies that may be used in the event that an adjustment is warranted. If other standards may be applicable, the examples should indicate that other calculations may achieve a more accurate result. Example 2 raises the same concerns.

76. Appendix 14 needs to have more precise definitions:

- ΔAR_T is calculated for each comparable. The current Equation 1 refers to plural "Comparables".
- In Equation 3, Adjusted Sales/365 should be calculated for each comparable. From the current Equation 3 it is unclear whose adjusted sales should be used because the variable is not defined.
- These are calculations intend to show how working a capital adjustment can be used as a proxy for country risk adjustment. Presumably, the rationale for this approach is that there is an argument that differences in working capital employed are a reflection of the differences in economically relevant factors such as country risk. Do these adjustments effectively result in the replacement of the amount of working capital of the tested party with an amount equal to the working capital the comparable. Would this be any different than making capital adjustments? If this is the case, the rationale does not support equating working capital to adjusting for country risk.

77. Appendix 15, Step 2, second line should be rewritten as follows: "…need to replace A2:A10 with the actual ~~values from~~ cell references in your data set."

    The same change should be made in Step 3: "Replace A2:A10 with the actual ~~values from~~ cell references in your data set."