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Submission by Transfer Pricing Economists For Development (TPED) by email: cfa@oecd.org

Subject: Comments on the OECD Public Consultation Documentation named "OECD Public Consultation Documentation Reports on the Pillar One and Pillar Two Blueprints" (Question X.b.)

14 December 2020

Dear Madam, Dear Sir,

We welcome the opportunity to provide comments on the OECD Public Consultation Documentation named "Reports on the Pillar One and Pillar Two Blueprints published on 12 October 2020".

Transfer Pricing Economists for Development ("TPED") is a Paris-based Non-Profit Organization aiming to promote the development and sharing of business economics knowledge in transfer pricing, notably in emerging and developing countries.

1. Overview

TPED has conducted economic research in the field of comparables in transfer pricing since 2017. Our work started with the request for further research made by the Platform of Cooperation on Tax[1] that called for more research[2] on comparability adjustments in the field of transfer pricing.

[1] The Platform for Collaboration on Tax (PCT) – a joint initiative of the International Monetary Fund (IMF), Organisation for Economic Co-operation and Development (OECD), United Nations (UN) and World Bank Group – has published a toolkit to provide practical guidance to developing countries to better protect their tax bases. The toolkit, "Addressing Difficulties in Accessing Comparables Data for Transfer Pricing Analyses", specifically addresses the ways developing countries can overcome a lack of data needed to implement transfer pricing rules. This data is needed to determine whether the prices the enterprise uses accord with those which would be expected between independent parties. The guidance will also help countries set rules and practices that are more predictable for business.

[2] Undertake further research and spread available good practices on measures that may be taken to use existing data more effectively. Such guidance might include the challenges, and options for using data from foreign markets, the use of data drawn from widened search criteria, and the use of comparability adjustments. There is limited evidence on the impact of geographic differences on profitability. This is an area which could benefit from further research, and the suggested mechanism for increasing the pool of data, described at point 1 above, may provide data to support such research (Toolkit for

For the purpose of our research project, TPED has partnered with Prof. dr. Bert Steens, full professor at the School of Business and Economics of Vrije Universiteit (VU) Amsterdam, Prof. Christof Beuselinck from IESEG School of Management and LEM France, and Prof. Matthias Petutschnig, from WU – Vienna University of Business and Economics, all members of TPED. TPED received modelling and statistical support from TP qube, a modelling and statistical firm.

We have regularly published updates and preliminary results[3] and are now in a position to present our final research findings on the subject matter. Our research paper is available on demand, prior to being published in academic reviews.

Our statistical analyses, performed on a large scale[4], support that country risk outperforms the geographical proximity factors. This suggests that, in the application of the arm's length principle notably in emerging/developing countries, country risk must be considered as a relevant factor for foreign comparables' selection, especially in case of lack of domestic comparables.

We see a direct link between our current research and the question X.b asked by the Secretariat, asking for considerations on the design and determination of Amount B: "*Do you consider that Amount B should account for variation in returns to baseline marketing and distribution activities by industry and/or region? If yes, what industry and/or regional variations should be considered? Are there any other differentiation factors that should be considered? [Refers to paragraphs 690-693 of the Blueprint])*".

The OECD Paper already acknowledges that Amount B may vary by « industry and/or region ». By extrapolating the results of our scientific study, we recommend the OECD to consider:

- **Adding country risk as a segmentation factor of Amount B,**
- **Acknowledging a higher Amount B in riskier emerging / developing countries than in less-risky developed countries,**
- **Determining Amount B, in the absence of local / regional comparables, by reference to comparables available in countries of the same risk level,**
- **Alternatively, applying country risk adjustments from comparables from developed countries to derive Amount B in emerging / developing countries, where comparables are lacking.**

Addressing Difficulties in Accessing Comparables Data for Transfer Pricing Analyses, by the Platform of Cooperation on Tax, page 84).

[3] Proposed Framework for Foreign Comparables Selection and Adjustment, Gonnet-Steens-Beuselinck-Pettutshnig, https://tped.eu/proposed-framework-for-foreign-comparables-selection-and-adjustment, November 2019.

[4] While our former study focused on the food processing industry, we now encompass all manufacturing sectors in our empirical study. We also rely on yearly profit metrics instead of 5-year weighted averages. These changes allow us increasing significantly the number of observations in our empirical paper from 1,042 to 51,402 observations. The extended dataset covers over 11,000 companies from 84 countries.

Our recommendations, grounded on our Research, cover the specific issue of the relevance of country risk segmentation of Amount B. Our Response does not aim to cover any other segmentation factor or cover other aspects of Amount B.

2. Summary of work performed

Many studies[5] have analysed impacts of country-specific factors and firm profitability. The results of these studies point at (political and economic) risk factors relevant for explaining actual and required firm profitability.

In the absence of related available research in transfer pricing[6], our research consists of applying explanatory analytics to investigate the relation between idiosyncratic country-specific risks of the location of a company (proxied by the sovereign rating of the country as an indicator for the specific economic circumstances of each country), and the profitability of the company. If, as suggested in literature, companies located in riskier countries are on average more profitable than their counterparts in less risky countries, the risk factor (proxied by the sovereign rating) must not be neglected as a comparability criterion and a segmentation factor in the context of searches of foreign comparables outside the domestic country where the tested party operates.

Our tests confirm the conjecture that the profitability[7] of firms is positively related with country risk. An interesting additional finding is that the outcomes of our tests show that geographical proximity is substantially less relevant for explaining profitability.

Our results are based on regression models, where we regress the ROS (Return on Sales) of independent companies on covariates, including a set of binary (0/1) dummy variables for the sovereign credit rating of the countries in which the company is incorporated which we call *CountryRating*. These dummy variables are used in order to differentiate between the profitability levels of the rating categories. The size of the companies is controlled for by a variable representing the sales of the companies. We provide two different specifications. One model includes additional binary dummies representing the region of the countries, while the other model excludes these dummies. This allows us to test the impacts of geographical proximity. Both models result in estimates for the coefficients for *CountryRating* that are

[5] See e.g., (1) Boubakri, Narjess, Sattar A Mansi, and Walid Saffar. 2013. "Political institutions, connectedness, and corporate risk-taking". Journal of International Business Studies 44: 195–215; (2) De Jong, Abe, Rezaul Kabir, and Thuy Thu Nguyen. 2008. "Capital structure around the world: The roles of firm- and country-specific determinants". Journal of Banking & Finance 32: 1954–1969; (3) Firat Demir. 2007. Determinants of Manufacturing Firm Profitability under Uncertainty and Macroeconomic Volatility: Evidence from an Emerging Market. Working Paper; (4) Ketelhöhn, Niles, Carlos Quintanilla. 2012. "Country effects on profitability: A multilevel approach using a sample of Central American firms". Journal of Business Research 65(12): 1767-1777; (5) and Koller, Tim, Marc Goedhart, David Wessels. 2015. "Valuation – Measuring and managing the value of companies". Sixth edition, University Edition. Wiley, Hoboken, New Jersey.

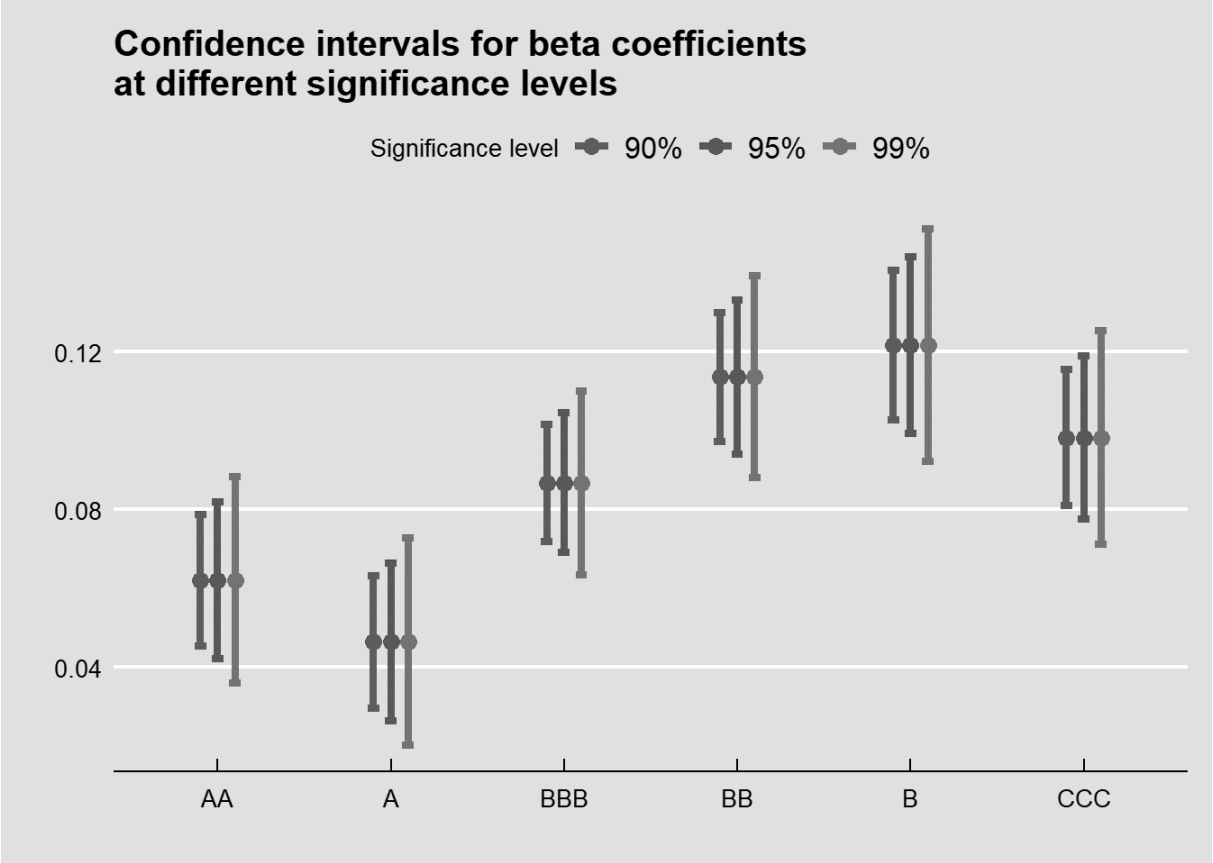
[6] Available transfer pricing related literature on comparability factors and adjustments is slim, as evidenced by a recent literature review on comparability adjustments by Petutschnig and Chroustovsky (2018). Petutschnig, M, and Chroustovsky, S., Comparability Adjustments A Literature Review, WU International Taxation Research Paper Series No. 2018-08, 1 Oct 2018.

[7] Defined as the Return On Sales ("ROS"), computed as EBIT / Turnover.

smaller for companies in AA-rated or A-rated countries than for companies in countries rated BBB, BB, B or CCC, which is in accordance with our hypothesis. Furthermore, these coefficients are all significantly positive, meaning that the contributions of all risk levels exceeding AAA are positive, which is also in accordance with our hypothesis.

Figure 1 below presents the confidence interval for each of the estimated coefficients (the betas). The profitability level of the companies in AAA-rated countries serves as the reference. Therefore, the positive outcomes for all coefficients (betas) for these dummies mean that the profitability of companies in AAA-rated countries is lowest. The pattern of the means of the coefficients (i.e., the estimates for the betas) and corresponding confidence intervals is consistent with our hypothesis. The only exceptions are the relationship between the estimates for the AA and A rated countries and the position of the estimate for the CCC rated countries vis-à-vis the BB and B rated countries. Additional statistical tests also confirm our findings.

Figure 1: Confidence intervals for the beta coefficients for *CountryRating* at various significance levels



3. Conclusions for the determination of Amount B

We infer that, in the absence of domestic comparables, foreign comparables should not be rejected in principle, and that there are merits in using foreign comparables from countries that have a similar country risk profile as the country of incorporation of the tested party. The

outcomes of our study suggest that selecting comparables originating from countries geographically close to the country of the tested party, even though appealing and widely used in practice, seems to have less relevance than country risk.

Our findings challenge a common intuition and typical transfer pricing practice that comparables from the geographically closest neighboring countries are by definition superior to comparables from other regions. It also provides some scientific foundations for using comparables from outside of the region of the tested company. For instance, Asian or South American comparables could prove to be relevant for African companies, allowing a much larger number of potential comparables.

Our work is relevant for the segmentation and determination of the Amount B within the current OECD Reform.

We note that the OECD suggests a determination of arm's length base-line distribution margins by « industry or region », disregarding potential heterogeneities in country risks within the same region. Such an approach may very well be detrimental to the (poorer) riskier countries within each selected region, which most of the time are also those with the smallest number of comparables.

The alternative that we suggest accounts for country risk as an additional segmentation factor and acknowledges higher baseline profits / Amount B awarded to these countries. Not only such an approach is sound economically, but it is also beneficial to emerging / developing countries at a time when revenue mobilization is a key development priority and essential to finance investments in human capital and infrastructure.

We trust the above is helpful and thank you again for the opportunity of providing comments. For the purpose of this submission, TPED can be contacted at sebastien.gonnet@tped.eu.

Yours sincerely,

On behalf of TPED[8]

Sébastien Gonnet, TPED President

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[8] The views expressed are those of the authors, not necessarily those of TPED or its other members. The views expressed are also not the ones of the affiliated organization of the authors.