



INVITATION TO COMMENT ON DISCUSSION DRAFT ON
TRANSACTIONAL PROFIT METHODS
RELEASED ON JANUARY 25 2008

CONTRIBUTION OF CMS ALLIANCE



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COMMENTS FROM CMS ALLIANCE

Preliminary note

CMS Alliance generally supports the Discussion Draft (“DD”), which provides significant insight and clarity on complex issues faced by practitioners. The purpose of these comments is to emphasize on certain items of the Discussion Draft which may raise certain concerns; in the interest of clarity and efficiency, CMS Alliance comments are presented under a summarized form.

1. Review of Transactional Profit Methods: status as last resort methods

CMS Alliance agrees with the approach aiming at removing the exceptionality for the application of Transactional Profit Methods (“TPM”), and supports the concept of “most appropriate method”. One can wonder however if, within the TPM, there should not be a distinction as suggested in §4 of DD: indeed, if TNMM, for the reasons described of comparability issues and of availability of the information, often happens to be, in practice, the “most appropriate method”, the profit split method remains much less usual and only appropriate to cases where there are exceptional situations, in particular unique intangibles.

Yet, such concept should be further defined in the proposed amendments to the TP Guidelines, as described under §16 of DD. As it is described, the “most appropriate method” seems to be very close to the “best method” as described in the U.S. Regulations for IRC Section 482; it can be observed that the application of the “best method” rule leads in practice very often to the choice of the “Comparable Profit Method”. The concern is that the “most appropriate method” rule could make TPM “by default” methods, and thus shift the status of TPM from exceptional to universal.

It would thus be helpful if the proposed amendments evidence how the OECD “most appropriate method” approach is different from the US “best method” rule.

In addition, while DD states correctly (§14) that “in countries where there is no or limited publicly available reliable gross margin information on third parties, traditional transaction methods might be difficult to apply in cases other than those where there are satisfactory internal comparables”, while the proposed amendments to the TP Guidelines provide (§3.27): “in addition, the lack of clarity in the public data with respect to the classification of expenses in the gross or operating margin frequently makes it difficult to evaluate the comparability of gross margins, while the use of net margins finesses the problem”. This proposed amendment seems to make a general rule, while the DD was stating that the lack of information existed in certain countries, and might make the application of the transactional methods difficult. The wording of the proposed amendment may be viewed as generally rejecting the methods based on gross margins, while in certain countries (France for instance), there is available information for computing a gross margin for a distributor.

2. Use of more than one method

In § 27, DD indicates that the use of more than one method would be appropriate in particular as regards transactions between a country accepting TPM and a country which does not; this seems to

recognize the possibility of OECD members not accepting TPM, which, absent reservation to the OECD guidelines, all OECD members should accept such TPM as described in the guidelines.

DD indicates (§37) that one of the cases of application of a TPM to check the outcome of a traditional transaction method could be to “check the consistency of the current period’s result with those of previous periods”. This case is also provided in the proposed amendments to the TP Guidelines (§1.69c).

This approach raises a concern: it would end up denying the consequences of exceptional events applicable one given year (bad market conditions, restructuring costs, etc.) where for instance gross margin on a distributor under the resale minus method would remain unchanged (hence the transfer prices) while the net margin would decrease further to the exceptional events, which are disconnected from intra-group relationships. Under an arm’s length approach, there is no reason to expect consistency between several periods.

Furthermore, tax administrations are tempted to apply TPM using an inter-quartile range (25% to 75%) to determine the arm’s length range, which generally ends up to show a “comparable” profit, while loss-makers remain in the first quartile (0 to 25%). OECD should emphasize that the full range (0 to 100%) of comparables is to be considered as the arm’s length range, and that the exclusion of certain companies can only be justified because of comparability standard, not merely because they report a loss or a high profit.

Another occurrence of the use of two different transfer pricing methods could be (i) to apply a transfer pricing method and (ii) to use a TPM as a floor, a safeguard: the idea is that the applied method cannot lead to a return on sale below a certain limit or to a share of the profit below a certain percentage.

3. Application of TPM and unique contributions

The following statement in § 77 is interesting but raises a concern:

“Secondly, because it is possible that a party to a transaction does not use significant intangibles but nevertheless should be entitled to profits that fall outside typical ranges of a TNMM, because for instance of unique contributions other than intangibles e.g. unique functions, tangible assets or risks, which would make the TNMM (as well as traditional transaction methods) inapplicable and could lead to the selection of a profit split.”

Actually, one can only agree with the statement. Yet, it seems to open too large a door for a general application of profit split. If the concept of a “unique intangible” is well-known, it seems more difficult to make a difference between routine functions, tangible assets and risks and unique functions, tangible assets and risks. It would certainly help if examples of such unique contributions could be provided, in order to restrict the application of profit split.

We strongly disagree with a portion of § 80: “however, experience has shown (...) that internal or independent third-party comparable uncontrolled prices (for royalties) are rarely available.” There are public databases available for search of license agreements which can provide some valuable information; indeed, there are sometimes limited to transactions where a US resident is a party, but they could provide information to build a comparable set.

§81 states that it may be “possible to use some form of resale price method to analyse the terms of the controlled transaction. This however is not the most common situation in practice”. We would like to point out that this is common practice in the software industry.

4. Application of the TNMM: selection and determination of the net profit margin indicator

§ 147 states that “the denominator should not be the transfer price of the controlled transaction under review, otherwise there would be no objective starting point.” This seems to be common sense, but actually we do not understand the economic rationale under such statement. We do agree with the final sentence of the paragraph where it provides that “caution should be exercised to ensure that said related party costs do not materially distort the analysis”, and we believe this is also applicable to all transfer prices of controlled transaction. Caution should be the principle, not exclusion.

5. Application of a transactional profit split method: how to split the combined profit

Proposed amendment to TP Guidelines under § 218 read as follows: “3.6 (...) the allocation of, profits is based on the division of functions (taking into account the division of assets and risks) ...”

This wording seems to put more emphasis on functions than on assets and risks. We believe the three of them (functions, assets and risks) should be placed on the same level.

§B (§220 and seq.) put a lot of emphasis on allocation keys to split the combined profit, making reference to asset-based or cost-based allocation keys. We believe the same emphasis should be put on qualitative methods to split the combined profit, based on value contribution analysis; obviously, this approach is more qualitative and subjective, but may constitute a better reflection of value generation than a mere cost approach.