



Mouvement
des Entreprises de France
MEDEF

Direction des Affaires Economiques, Financières et Fiscales

Position paper of the MEDEF on comparability
20 décembre 2006

◆ **General and 1st draft Issue**

1. Status of the draft issue notes

For us it is a working document that should result in the review of the 1995 guidelines and not as supplementary guidelines.

2. Status of comparison

The basic principle on which the 1995 guidelines are build up is the "arm's length principle" and the comparison is just an instrument to apply the principle.

The arm's length principle is about conditions which would have been contracted between independent enterprises:

§ 1.6 The authoritative statement of the arm's length principle is found in paragraph 1 of Article 9 of the OECD Model Tax Convention, which forms the basis of bilateral tax treaties involving OECD Member countries and an increasing number of non-Member countries. Article 9 provides:

"[when] conditions are made or imposed between ... two [associated] enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly."

By seeking to adjust profits by reference to the conditions which would have obtained between independent enterprises in comparable transactions and comparable circumstances, the arm's length principle follows the approach of treating the members of an MNE group as operating as separate entities rather than as inseparable parts of a single unified business. Because the separate entity approach treats the members of an MNE group as if they were independent entities, attention is focused on the nature of the dealings between those members.

Comparison is a method to try and approach the arm's length principle.

§ 1.15 "application of the arm's length principle is generally based on a comparison of the conditions in a controlled transaction with the condition in transaction between independent enterprises (...)"

It is highly doubtful that the conditions of a transaction between two independent enterprises are fixed according to the transaction between other independent enterprises in the market. In fact, each party in the transaction tries to optimise the conditions of the transaction on the basis of several criteria which include return on investment, gross margin, resale prices, marketing strategy, etc... The price agreed between other enterprises is just information among others and an unrelated party will not imitate what it sees in the market because pricing depends on its own strategy, long term vision of market share, expected return on investment, cash policy, etc...

Therefore, the main uses of the comparison are:

- for the enterprises to check that their international transfer prices are not significantly different from what can be observed in the market and if significant variances appear, to provide for an explanation (see § 2.5);
- for the tax authorities to detect the prices that are significantly different from market prices and to check whether there are good reasons to that situation.

The draft Issues should be slightly reworded in that perspective. In particular, § 1 and 3 of the 1st draft Issue ("*Putting a comparability analysis...*") should not mention "*... why comparability is needed...*" (except for tax auditor maybe) or "*...in the foundation for comparability because it introduces the need of a comparison...*". Comparison is needed among several other elements.

3. Burden of providing comparable

The enterprise has a double handicap in providing data as comparable:

(1) The enterprise has no access to the conditions of the transactions between other unrelated parties. Indeed, condition includes not only prices but the period of application of the price (it could be a temporary one to start a new relation), the payment conditions, some additional services from one party to the other. All these conditions are normally not known by a person not involved into the transaction.

(2) The information the enterprise can obtain are normally obtained after the transaction between unrelated parties have been completed, i.e. 'ex-post', while according to the arm's length principle, an international transfer price should be fixed at the beginning of the period to which it applies, i.e. 'ex-ante'.

On the contrary, the tax administration when it audits the transfer prices has a larger knowledge of the conditions realised between unrelated parties because (1) it can ask the information from those parties and (2) it completes the audit some months or years after the audited period.

Therefore, one cannot expect the same amount of knowledge and documentation from the taxpayer and from the tax administration. § 9 of the 1st draft Issue strangely states in its first sentence that the tax payer should provide all the documentation that "allow the tax administration to determine the quantum of the adjustment" to be made. One can wonder in which situation such documentation could be available to the tax payer.

This has to be reflected in the various draft Issues.

4. Transfer pricing as a subject

Transfer pricing is not an exact science and it relates exclusively to the economic life, where common sense and pragmatic approach dominate, rather to a legal and formalist domain.

Therefore, the treatment of comparison and comparability should not follow a pattern of unrealistic formalism or a path similar to the Sarbanes Oxley obligations.

Particularly, one must not expect from the taxpayer more than what he can deduct from what he really knows as a prudent business manager.

We would have suggested that the document started by the presentation of the 10 steps approach. Each of the key points outlined by the OECD in the 12 sections of the document would have been addressed in a chronological and logical manner.

We strongly believe that by addressing the key points in a structured and logical way using the 10 steps will assist in reducing the number of discussion points between taxpayers and tax authorities.

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◆ 1. **Putting a comparability analysis into perspective**

We agree on the document when it reminds some priorities:

(1) that, first, the tax payer has to determine how transfer prices should be established and that, second, tax administration can determine whether a transfer pricing adjustment may be made, provided such adjustment is properly supported ;

(2) that the analysis of the taxpayer controlled transaction and the comparability analysis come first and then the search for comparable can take place to the extent it is required.

It implies that there is no automatic need to use databases and that the search for comparable depends on the analysis of the actual case (to select the relevant data) and on the amounts at stake (to measure the necessary efforts).

As comparison is more often an audit technique for the use of the administration than a way for the tax payer to determine the transfer price, there is no obligation for the latter to have all the comparables on a contemporaneous basis neither to have them when sending the tax return. Comparable would most often be required when the prices are challenged by the tax administration.

It is acknowledged that comparable search must not be separated from the other steps of comparability analysis. The comparability analysis and comparable search remain closely tight in order to :

- focus on analysis' quality rather than on mechanical index comparison.
- ensure a reasonable and balanced compromise as regards to taxpayer's burden.

In this perspective, the "prudent business management" notion proves highly relevant even if it undoubtedly requires some clarification. It is even a relevant concept to be used as a substitute for comparables when there is no way to identify any of them. This hypothesis of construction of a theoretical arm's length environment would once again certainly benefit from further development.

There is in the document an authentic care of emphasizing qualitative aspect beyond the quantitative one, what deserves to be stressed and we approve on it. The problem of the cost for companies, particularly for small business ones, is set up. Moreover, SME's need a specific treatment up to large exemptions of obligations.

Yet, if certain pragmatism and the application of the "proportionality" principle are promoted, this recommendation is not concretely made.

◆ 2. Timing issue in comparability

We are of the opinion that independent parties generally fix prices prior to the period during which they apply, on the basis of the information available at that moment and according to their vision of their own business at the moment. From time to time prices may be revised, on the basis of the information and plans at that revision time.

Independent parties would hardly make an adjustment of price "ex post facto" because it would introduce an uncertainty that is not in line with real economic life. It must be reminded that a transaction is part of a chain of transactions between several parties (including related and unrelated ones) and a change of price cannot be passed on to the following customer.

Therefore, there is generally no need to re-examine the price of the past period under the line of ex post information.

Such principles must indeed be applied to controlled transactions. If, after a discussion with the tax authorities, it appears that an adjustment is necessary because the determination of the original transfer price was not in line with the arm's length principle at the time of the determination, then the adjustment of the tax basis would lead to an equivalent adjustment in statutory accounts because the right price is the one that is right from an economic point of view, according to a prudent business management principle.

Information to be used is the information available at the time when the data are needed for the computation. Therefore, it does not seem appropriate to try and impose to taxpayers to make adjustments taking into consideration *ex post* data, even if the information that was used at the time of the computation was referring to former years data.

To our point of view, the Working Party should be clearer on that point.

Concerning the production of the justification to the tax authorities, the taxpayer should be able to provide such information when requested in the course of a tax audit but we do not consider it feasible nor appropriate to provide complete information at the moment of the tax return filing date (too expensive to provide TP study for all transactions / business and timing issue for the collect of the information).

Information *ex ante*, at taxpayer's disposal on transaction date should be the principle, for both transactional method and profit split. Documentation *ex post*, when legally imposed in some countries, should be strictly limited to cases in which a huge difference between the compared item and the so-called comparable appears; in addition, precedence should be given to existing *ex ante* documentation provided by the taxpayer.

Contemporaneity should be linked with the availability of data and reference to posterior data should be, in principle, excluded (this remark is also relevant for data that were available after the transaction event though they are related to period preceding that transaction).

Moreover, there is no clear definition of price testing & price setting which drives to different interpretation per country and therefore can create double taxation issues.

◆ 3. Internal comparable

The document insists on the priority of internal comparables on external ones, a point which does not seem obvious in the current Guidelines.

It appears to us that the two different kinds of comparables should be treated equally and chosen by taxpayers according to their relevance.

Giving priority to internal comparables may lead to extra documentary obligations because the tax payer will then have to explain why he did or did not use the internal comparables. This statement is contradictory to the objective of lightening the documentary obligations and could lead to conflicts between administration and tax payers.

Therefore, it is important not to establish a hierarchy in the choice of comparable (internal then external), in order not to incite the tax authorities to reverse the burden of proof.

Moreover, the notion of « other parties of the group » should be more precise and, falling back on existing internal comparables within other parts of the group should be strictly framed so as to avoid any abuses, especially from the tax administrations.

Besides, the availability of data from other group companies who are not parties to the transactions being examined could be a difficulty as the data may not be available.

◆ 4. Determination of available sources

Public databases can be useful, however their use must not be imposed upon the taxpayer. They are costly and may provide data that are not in line with the needs of controlled transaction analysis.

They should not be compulsory thus and a taxpayer should not have to justify why he did not use them.

We are strictly opposed to the use of secret comparable. It is a clear breach of the right of defence granted to the taxpayer. Comparability involves not only prices but conditions, content of the agreement, anteriority and fame of a trademark, unicity and originality of a technical element protected (or not) by a patent, etc... all elements that need to be examined together between the taxpayer and the administration.

Such use of 'useful' information is all the more dangerous than it is contemplated 'especially where no better information is available' (§ 12). It cannot either be presented as a sort of sanction 'in case of a tax payer's failure to comply with reasonable document requirement' (§ 16) because comparability is no part of a 'criminal' procedure.

The use of secret comparable within the MAP means that the taxpayer is excluded from the procedure, which is in a way the case currently but which is necessarily to be amended.

Secret comparables encourages the non-transparency of tax administrations and deprives taxpayers of any defence as they cannot check whether secret comparables are really appropriate to their case or not.

The use of secret/confidential information should be excluded in any case.

The OECD should rather put emphasis on the need for tax administrations to try and take into account the reasonable efforts made by taxpayers to find relevant information and accept that they can use another method when no comparable with sufficient public data is available.

Besides :

- No clear indication of a more pragmatic approach of the use of local versus regional versus global comparables could force the taxpayer to provide all three. This would also create issues of consistency and ranking between all searches.
- Proprietary data base sourced comparables does not create a replicable, traceable, transparent audit trail.

◆ 5. Uncontrolled transaction

We are not in favor of any use of controlled transactions because they do not meet the requirement of the provisions of Article 9.

We could add that they would not be more available or more reliable than the uncontrolled transaction so that it is illusory to think they are a fall-back solution.

However, watching controlled transactions in case of unavailability of uncontrolled ones may provide useful information in very specific cases.

The issue is so complex that tax administrations should be advised to evaluate the reasonable efforts made by taxpayers for their comparable searches, rather than apply too strictly the independence criterion. Indeed, this criterion may lead to potentially comparable uncontrolled transactions being less comparable in respect of the other comparability criteria.

In certain circumstances (i.e., financial sector, comparable markets, ...) there might be reasons why enlarging the scope of comparables to other geographical sectors or to markets of other kind appears to be appropriate for the MNEs. However, this approach should be limited to exceptional circumstances and cases, since the consequence of such an enlargement would be only to postpone the need for calculating the differences linked to those various sectors or markets in order to correct such differences.

◆ 6. Examining the five comparability factors

We agree with a pragmatic approach in which some factors can be lacking if they prove not to be of sufficient importance in the case.

One must keep in mind that 'business strategy' covers several components (business model, by region and by product group, finance strategy, financial market expectation and constraints, etc...) that are constantly and continuously changing in time and space.

Functional analysis and five comparability factors are key elements.

The limited level of detailed information in database does not allow a (full) validation of the 5 comparability factors in the analysis.

◆ 7. Selecting or rejecting

Even if this specific point does not raise, according to us, any material issue, we can remind that the OECD Guidelines should remain guidelines and not become too strict rules: in the present case, no further guidance has to be given, and it is important to leave the choice to taxpayers to use the best possible approach given the facts and circumstances of their own case.

In the event of a disagreement with the taxpayer, tax administrations should justify their position and their alternative choice, and not make "cherry picking".

◆ 8 Determination of and making comparability adjustments where appropriate

Let us first remind that the adjustment in profit can only result from the conclusion that the conditions of a transaction differed significantly from those which would have been made between independent enterprises. Comparison is just a method to try and find whether there is a difference or not. The difference is significant only if the conditions of the controlled transaction fall out of the arm's length range.

Guessing what conditions independent parties would have adopted is an impossible task so that the valuation of the adjustment to be made, if proved necessary, is not far from impossible.

The approach should thus be pragmatic and inspired by common sense. Neither exhaustive list nor formula can compensate for the difficulty of determining an adjustment.

Moreover, we agree with the mention that adjustments cover a large variety of calculation and with the recognition that an adjustment has to be transparent, traceable, documented, to pass the validity test.

◆ 9. Multiple year data

The legitimacy of resorting to multiple-year data should be fully acknowledged. The period to be taken into consideration should depend on each specific case since :

- markets are sometimes quickly moving, sometimes rather stable;
- the company's strategy can change as well;
- products are continuously modified in a large number of sectors.

A taxpayer should be able to use, because it fits its business cycle, several years to show that over this period it is earning an arm's length return. If over that period it falls outside the arm's length range then adjustment on a year by year basis should be made, however if over that period it is earning an arm's length range then it should not be subject to adjustments.

Therefore, taxpayers must have the choice to select one or several years to make a use of the data either as a trend or as an average and in the latter case to adopt the best set of weights adapted to the specific case.

In parallel, it could be envisaged to analyse the transactions of the tax payer also on the basis of several years data with a fitting weight; if an adjustment results from this several years average comparison, it would be applied on a yearly basis for years needing an adjustment; this approach would be more meaningful and realistic since it would be less short term oriented and more in accordance with economic approach.

Principles could be completed with examples. Multiple year data is a valid method, and this is not incompatible with a vision of the company's profit on a one-year period. There is not much to object to this positive evolution, as the situation is quite consensual, until a distinction is made between multiple year data and statistical tools.

Furthermore, since multiple-year comparison data can be of benefit, it should be possible to consider that transaction appreciation could be dealt with on this very cycle that was selected for comparables (possible adjustment on a multiple-year basis). This new opportunity is likely to enhance reliability as a consequence of the widened range of controlled transactions and leading to a greater homogeneity between the compared transaction and comparables used.

◆ 10. Aggregation of transaction

It is important to simplify the analysis of the tax payer transfer pricing method and reduce the costs incurred for the transfer pricing documentation; therefore when a method is applied, explained and justified by comparables (whether aggregated or not) the confirmation by other methods should not be necessary.

The OECD must clearly recognise that information on individual transaction is hardly available, and aggregated data have to be fully accepted. However it is important that transactions which are aggregated be sufficiently homogeneous to be considered as one.

Giving more legitimacy to aggregated data appears to be a necessity.

◆ 11. Definition of the arm's length range

We are of the opinion that when a set of acceptable comparable has been obtained, it then makes the arm's length range.

Statistics is of no help in such circumstance as transfer pricing is not an exact science. The right price is the one determined by the tax payer until it is proved to be out of the arm's length range, so that there is no 'true' price to be researched through scientific scanning techniques.

Now that debate is launched and diverse opinions presented, one can however hope that certain pragmatism will now prevail on ambiguous positions.

Once more, we face an opposition between a strict application of principles (very selective choice of comparables, required to be of a great quality if not perfect) and an actual realism (using statistical tools to enhance the reliability of a statistical sample).

- The comparable approach should try to avoid excessive complexity.
- Available data is usually limited and does not enable to have a comprehensive view of the compared situation.
- Statistical analysis is a tool for comparable approach. One cannot expect from it more than what it can provide.
- The approach must keep as much flexibility as possible. Interquartile analysis must not be compulsory and the statistical analysis should not be limited to the pure analysis of the interquartile range.
- On extreme points, a case by case analysis must be made. Those extreme points define the arm's length range and they should not be excluded *a priori*.

We support the argument that:

- analysis of the comparability is a key point during the selection process.
- statistical tools are more statistically relevant and valid when the sample is large.

◆ **12. Documenting research for comparable**

We agree that guidelines must be devoted to the necessity of documenting research for comparable, when comparable have proved necessary. Nevertheless, we think that the organisation of its documentation has to remain the company's choice.
