

CONTRIBUTION RECEIVED FROM CONFEDERATION FISCALE EUROPÉENNE

The Confédération Fiscale Européenne (C.F.E.) is glad to be able to accept your invitation to comment on comparability issues, for taking into account by OECD as part of its procedures to monitor implementation of the 1995 Transfer Pricing Guidelines (“the Guidelines”).

General

In doing so we would like to make our general position in one respect quite clear from the outset. The C.F.E. continues to support application of the arm’s length principle as the appropriate means of determining applicable transfer prices for transactions conducted between associated parties. We note that this area continues to assume increasing importance given not only the growth in international trade but also the proposed application of the arm’s length principle, by analogy, in relation to dealings entered into between the various parts of a single enterprise as well as its application in a purely domestic setting in a number of countries. Whilst issues of comparability in order to apply the arm’s length principle increasingly arise in all these situations, it remains the case that, for all the reasons set out in paragraphs 3.58 to 3.74 of the Guidelines other so-called global formulary apportionment methods should continue to be rejected.

Issues on Which Comments Invited

Issue 1

The requirement to perform an analysis of transactions is often a difficult one to satisfy because of the problem of locating adequate data for third party transactions for which the tests of comparability can be satisfied. From this perspective the ability to aggregate transactions provided for in paragraph 1.42 of the Guidelines is both necessary and appropriate and may well reflect the linking of transactions sometimes found between independent enterprises. Nevertheless, it is a process that has its limitations and should be applied with caution as reflected in paragraph 1.43 of the Guidelines. Extending the principle so that it may allow the comparability analysis to be performed at the whole entity level could be both inappropriate and dangerous. It would be inappropriate unless there was strong comparability between the entities in question. It is rare for any two companies to be sufficiently comparable to ensure that this approach would be reliable. It would be dangerous in the sense that it might suggest use of industry averages as being acceptable – which, as pointed out in paragraphs 1.16 and 3.4 of the Guidelines, they are not. For the foregoing reasons, we believe the present requirements in this respect should be sustained.

Issue 2

One difficulty related to identification of reliable third party data arises from the extent to which transactions conducted between associated enterprises may not frequently be found between independents. This is reflected in the Guidelines at paragraph 1.10. The issue arises whether, in light of such difficulties, transactions between associated parties may themselves be relied on as potential comparables. The C.F.E. considers that such determinations can only appropriately be made on a facts and circumstances basis, taking into the account the level and type of association in question. For instance, it may be that two entities conducting transactions between them are associated under the relevant shareholder relationship standards set by their home jurisdictions yet there may be significant non-associated shareholders ensuring

that business must be conducted on arm's length terms. There should therefore be no systematic exclusion of such transactions from consideration and paragraph 1.70 of the Guidelines should be clarified to reflect this. At the same time it is imperative that taxpayers should not be expected to take "on trust" the assertion by a tax authority that transactions between associates are "untainted" by their relationship and should have the relevant information necessary to enable them to make their own appraisal.

Issue 3

In the same way, a degree of flexibility can be supported, on a case by case basis, in judging the need to satisfy all five of the comparability factors set out in paragraphs 1.19 to 1.35 of the Guidelines. Problems for companies in this area are increasingly exacerbated by the limitations generated by the need to avoid infringing competition law.

Issue 4

Lying at the heart of the equitable application of the arm's length principle is a transparent and systematic approach to the identification of comparables. Transparency is particularly important in ensuring fairness. All parties should be prepared to demonstrate the basis on which initial selections were arrived at and how exclusions were then made. A vital aspect of this transparency is that selections should only be included where based on information to which both the administration and taxpayer have access. OECD is urged to specifically reject the use of so-called "secret comparables" as unfair and as contrary to the existing principles set out in paragraph 3.30 of the Guidelines and the obligation on both taxpayers and tax administrations to make a "good faith showing" that the determination of transfer pricing is consistent with the arm's length principle (Guidelines paragraph 4.16). A systematic approach to identification of comparables is also important in ensuring that there is no "cherry picking" to suit either the taxpayer or tax administration.

Issue 5

When companies set their prices, both with third parties and with associates, they make decisions based on market conditions at the time – not on the basis of prices for comparable transactions entered into in earlier periods. This may well include taking a view on appropriate margins informed by a judgement of past years standard reference conditions, but it will be acknowledged that, for example, there may be huge variations in some industries within a year, let alone over a business cycle. The real issue in this respect is that the arm's length nature of a taxpayer's transactions should be tested based on the soundness of the approach it has used as part of this process, including the business assumptions it has adopted. By contrast, tax administrations have the luxury of being able to consider matters by looking back over a year with the benefit of hindsight and tend to make judgements based on how the market has as a fact performed. The use of multiple year data allows some moderation of the effect of this but is not a complete answer since it fails to take account of influential events causing market changes which may well not have been forecast at the time an enterprise set its prices. The Guidelines should emphasis these business realities more and provide for an approach more closely allied to that adopted by companies in setting their prices as described above.

Issue 6

It is common, as part of the process of establishing the arm's length nature of transactions, for both taxpayers and tax administrations to rely on commercial databases. This is often an approach chosen where there are no internal comparable uncontrolled transactions. The use of such databases means, at least, that a systematic and transparent approach is being adopted. However, it must be borne in mind that databases in some countries are very limited in the levels of data they can provide, and some databases can be skewed where they rely on company input that may be influenced by an element of market-positioning. Where this is the case, the use of more reliable databases applicable to companies in other countries should not, in principle, be rejected outright. Whilst such other databases would then need to be used with great

caution to take account of, for example, different accounting standards as well as differences in the size and nature of markets, they may allow for establishment of reliable comparables.

Issue 7

On the subject of making adjustments to improve the reliability of comparables, the Guidelines already provide guidance on the approach to be adopted generally in paragraph 1.17, supplemented, as required, by reference to the individual transfer pricing methods. Whilst it would be useful to further supplement this guidance, there is a danger that doing so may create a misleading sense of what can reasonably be achieved in any individual case and reduce the present tolerance of the Guidelines in this respect. That would be counter-productive. It is suggested that rather than extend the narrative in the Guidelines relating to this issue and risk making it too prescriptive, this is an area in which examples could usefully be developed to illustrate the appropriate processes.

Issue 8

The Guidelines at paragraph 1.45 et seq correctly reflect the fact that there will often be no one single arm's length price for a given transaction. Independents strike different bargains for what are fundamentally comparable transactions. It is therefore a fully appropriate application of the arm's length principle to recognise that there may be a range of prices falling to be taken into account. It is our view that when a transaction satisfies all the tests of arm's length comparability, then there are no grounds to exclude it from such a range and it should not be excluded. Similarly, in the real commercial world, parties transacting at arm's length sustain losses. This may be due to many reasons as diverse as lack of effectiveness in the individual company or weakness in the industry in which it transacts business. There is no valid reason to exclude such instances from a range if the losses are indeed brought about by such arm's length factors. Removing the top and bottom from any range simply creates a new top and bottom and lacks logic. This assumes, as indicated, that the transactions in questions all satisfy the tests of comparability for the purposes of the range. If they do not, then they should not be included in the range in the first place.

Issue 9

Comparability issues are of particular relevance in applying the transactional profit methods. As paragraph 3.54 of the Guidelines points out, the recognition of such methods is not intended to suggest that independent enterprises would use these methods to set prices. It follows that locating arm's length comparables is particularly problematic in relation to application of transactional profit methods. Because of this and other concerns already set out in the Guidelines we believe that these methods should remain methods of last resort.