REPLY TO THE OECD'S REQUEST FOR COMMENTS ON THE
"DRAFT HANDBOOK ON TRANSFER PRICING RISK ASSESSMENT – 30 APRIL 2013"
FROM CMS

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Introduction

Transfer pricing ("TP") has been a subject of growing concern for countries and companies over the past years. In view of the current trends, the focus on TP will continue to narrow in the upcoming years.

We understand that the *Draft Handbook on Transfer Pricing Risk Assessment* dated 30 April 2013 (hereafter the "Handbook") aims at raising tax administrations awareness of the advantages that may derive from a proper evaluation of risks relating to TP. In particular, it highlights ways to improve tax audits' efficiency that may be reached when the risk is correctly qualified and quantified. The Handbook specifies that it considers the step prior to a tax audit and that it actually addresses the elements to be taken in consideration in the decision making of conducting a thorough tax audit in the framework of TP or not. With this regard, it provides, as intended, very detailed indications to countries as regard TP risk assessments. These indications may also be used further in the context of pending tax audits.

Since the Handbook is addressed to tax authorities of developing and developed countries, and aims at sharing the TP risk assessment know-how of experienced tax authorities, we welcome the fact that the OECD invited us to comment on the said Handbook.

As a preliminary remark, we would like also to welcome the fact that taxpayers are presumed as willing to elaborate TP policies that comply with the arm's length principle.

General observations

- ✓ Terminology

1. The Handbook aims at evidencing signs that could alert tax administrations of a potential transfer of benefits abroad. These signs could trigger a thorough audit of TP. This step corresponds to the risk assessment phase. However, the risk assessment phase is not precisely defined by the Handbook and the moment when the risk assessment phase takes place is not specified (e.g., is it an ongoing process or is it a process to perform every two or three years ?). By essence, this step is likely to create a presumption of transfer of benefits abroad in the mind of the tax auditors. Taxpayers should therefore be in a position to provide explanations about transfer prices implemented even at this stage of the process.

2. Furthermore, the term "risk" does not reflect the same reality for tax administrations and taxpayers. On the one hand, for tax administrations, the risk lies in the erosion of the taxable income by taxpayer and in the potential of shifting income. Conversely, the risk for taxpayer lies in the reassessment of the taxable income by the tax administration. Such as the "risk assessment phase", the notion of risk could be defined further.

3. The expression "sophisticated tax planning structures" (§46) would benefit from further clarification, especially in a multinational context, as countries may have different definitions of such structures and, especially, different views of the limit beyond which sophistication could become abusive.

4. In this regard, we suggest that the Handbook not only mention but also be in line with Chapter IX of the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations ("OECD Guidelines") under which tax optimization is viewed as a perfectly legitimate business decision. Pursuant to Chapter IX, §§9.181 and 9.182 of the OECD Guidelines:

"*9.181 Under Article 9 of the OECD Model Tax Convention, the fact that a business restructuring arrangement is motivated by a purpose of obtaining tax benefits does not of itself warrant a conclusion that it is a non-arm's length arrangement. The presence of a tax motive or purpose does not of itself justify non-recognition of the parties' characterisation or structuring of the arrangement under paragraphs 1.64 to 1.69.*

9.182 Provided functions, assets and/or risks are actually transferred, it can be commercially rational from an Article 9 perspective for an MNE group to restructure in order to obtain tax savings. However, this is not relevant to determine whether the arm's length principle is satisfied at the entity level for a taxpayer affected by the restructuring (…)."

- ✓ <u>Reference to the OECD Guidelines</u>

5. The Handbook outlines that it aims at assembling the recent TP risk assessment procedures, methods and practices of certain tax authorities in order to serve as practical tool for others to define or improve their procedures, methods and practices (§4). However, we were surprised to notice that the Handbook does not mention the OECD Guidelines throughout the text.

6. We thus suggest that the Handbook expressly refers to the OECD Guidelines and specifies that risks should be considered in view of the latter. It indeed appears useful to note that the Handbook serves as a practical tool for tax administrations to verify that the OECD Guidelines have been properly applied by taxpayers and that only when there are clear signs that the Guidelines were not properly applied, is there a risk of a potential transfer of profit abroad.

- ✓ <u>Reference to the OECD TP methods</u>

7. In the continuation of the above comment, a reference to the OECD methods also appeared as useful, in particular in §3.2.1.1 of the Handbook. This paragraph focuses on companies' profitability as a potential risk indicator for tax administrations. The first section of this paragraph address the comparison of such profitability *"to industry standards or potentially comparable companies"* (§3.2.1.1.1) and refers directly to financial ratios. However, should

the taxpayer implements the resale price, the cost plus or the transactional net margin method, a comparison of the companies' profitability with industry standards or potentially comparable companies is not necessarily relevant. Indeed, implementing these methods, the profit of the entity considered as the entrepreneur is not determined through a benchmark. It needs to be emphasized that profitability comparisons with the entrepreneur's do not make necessarily sense in the context of identifying a transfer pricing risk.

8. Furthermore, the second section addresses comparison *"to related parties or group results"* (§3.2.1.1.2). The latter seems to refer to a profit split method. However, such comparison does not make sense in the context of an OECD approach that consists solely in testing the arm's length remuneration of the routine entity. By systematically advocating for the profit split method, the Handbook creates a significant risk that tax administrations consider the profit split method as "the" right transfer pricing method in all circumstances. This is in total contradiction with the OECD Guidelines.

9. Furthermore, any such comparison "*to related parties*" would be inconsistent with the arm's length principle. Article 9 of the OECD Model Tax Convention states that: "(*where) conditions are made or imposed between the 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*". The Handbook should therefore stress that the various comparisons envisaged should be performed (and their results should be used) with great care.

10. We thus suggest that the risk assessment be generally performed in view of the OECD methods implemented by the taxpayer. It confirms the necessity to have the taxpayer involved in the risk assessment phase as explained in paragraph 1 above.

- ✓ Local vs. international standpoints

11. The Handbook advises local tax administrations as regard the risk evaluation of TP from a local tax perspective. By nature, tax administrations are concerned by the sole impact of TP on local taxable income. It thus advises tax administrations from a local point of view. For example, it recommends considering the *"magnitude of the transaction in the context of a particular country"* (§25) as one of the element of risk evaluation.

12. However, it should be noted that some of the local elements pointed out by the Handbook as potentially relevant of a risk are not taken in consideration by taxpayers that implement their TP policies at arm's length according to the OECD Guidelines. For instance, groups will often in practice perform an economic analysis covering a given geographical area with financial data extracted from a public database. We would urge the OECD to make it clear for tax administrations to put things into perspective by explicitly accepting regional benchmarking approaches. This is also of particular relevance to jurisdictions where

appropriate local economic data may not be routinely available, irrespective of whether the tax authority has or has not already explicitly acknowledged that regional benchmarking is likely to be appropriate for domestic analysis.

13. Such documentation of a TP policy would comply with the OECD Guidelines and, in particular, Chapter I §1.58, that recognizes the relevance of the analysis of a geographical area or region composed of several countries, which market conditions may be considered as similar.

14. It is therefore surprising to read in §110 of the Handbook that *"careful attention should be given to differences between companies in the data base and those in the local market"*.

15. We believe that local analysis must be performed taking into account international standpoints and standards. Otherwise, the Handbook would increase the administrative burden for multinational enterprises that would have to perform a country by country analysis. In the particular frameworks of the Handbook's §110, the assertion mentioned above should be clarified in view of the OECD Guidelines and taking in consideration the data available to a company at the time it implements its TP policy in order to prevent tax administrations from requiring systematically local comparable companies.

16. By recommending a local approach and by not referring to the OECD Guidelines, we are concerned that the Handbook creates significant additional works and new risks for taxpayers.

- ✓ <u>Risk of presumption of transfer of benefits abroad</u>

17. Going through the report, we understand that risk assessment logically takes place before commencing an audit. Indeed, the risk assessment stage triggers transfer pricing cases for a thorough audit where the tax administration identifies a high degree of risk. By nature, such a preliminary work is likely to create presumption of transfer of benefits abroad in the auditor's mind. Furthermore, the Handbook provides that "*a quantitative evaluation of the amount of potential tax at stake should form part of the risk assessment process*". We are concerned that this may create confusion between risk assessment and potential adjustment assessment.

18. As a consequence, there is a risk for MNEs, created by the Handbook, that the auditor forms an opinion on the adjustment to be made before even starting the "true" audit process. We suggest that the Handbook notes that the signs of potential mispricing detected during the risk assessment phase do not necessarily mean that non-arm's length prices were implemented by the taxpayer and that the existence of non-arm's length prices must be verified during the actual audit on the basis of additional / more precise facts and analyses. In that regard, the Handbook should insist on the fact that, in spite of the risk assessment phase, the team in charge of the tax audit should be sufficiently "open minded" to hear and accept explanations provided by the taxpayer. We are very concerned that the Handbook could allow auditors to definitively conclude to the existence of non-arm's length pricing on the basis of irrelevant upstream analyses.

- ✓ Low-tax jurisdictions

19. Such presumption of benefit transfer is further accentuated where transactions take place with related parties in a low-tax jurisdiction. Indeed, §3.2.1.2 of the Handbook provides that "*there is a risk that mispricing will incorrectly attribute excess profits to the low-tax jurisdiction*" and that "*careful consideration should be given to the possibility that a thorough audit is required*". It is thus surprising not to find a definition of what constitutes a low-tax jurisdiction while this is a recurring concept throughout the Handbook. We thus suggest that the Handbook expressly defines this key concept.

20. Furthermore, instead of speaking of "low-tax jurisdictions", we were wondering whether the concept of non co-operative/ non transparent countries and territories would be more appropriate (given in particular the works of the OECD and others in that field), with, for example, specific reference to existing lists of such jurisdictions to the extent that such categorization may have a material impact on TP audit and risk assessment procedures.

21. Besides, we would like to underline that the existence of transactions with related parties in tax jurisdictions where the corporate income tax rate is lower than in the country where the audit is conducted is not *per se* conclusive evidence that taxpayer has engaged in transfer pricing manipulation. We would welcome that the Handbook envisages that legal persons may be established in low-tax jurisdiction not only for tax purposes, but also for sound business reasons.

- ✓ Profit split method

22. We would like to stress - and challenge - the importance given to a profit split approach throughout the Handbook. For instance, in §3.2.1.1.2 the Handbook advises tax authorities to "*look at the results of the company in comparison to those of the related party which is on the other side of the identified controlled transactions*" without making any connection with, or taking into account in any way, the TP method selected by the taxpayer. However, such comparisons seem only applicable when the profit split method has been chosen and applied by the taxpayer as an appropriate TP method taking into consideration particular facts and circumstances of the case.

23. Conversely, other methods specifically recognised in the OECD Guidelines and predominantly used by companies as well as by tax administrations themselves in a vast majority of audits are 'one-sided' methods which solely seek to price the appropriate return to one of the parties to a controlled transaction without any regard to the results of the other party or the group.

24. Whereas we understand tax authorities "appeal" to gain a full knowledge of both the overall trade of the enterprises and the profits made by all the connected parties, it seems rather inappropriate to systematically implement (or favor implementing) a profit split approach. When one-sided TP methods are relevantly used as TP methods by MNEs, implementing a profit split approach would indirectly consist in requiring companies to meet several OECD methods' requirements at the same time, which is in contradiction with the OECD Guidelines. Paragaph 2.11 notes that: "*(t)he arm's length principle does not require the application of more than one method for a given transaction (or set of transactions that are appropriately aggregated following the standard described at paragraph 3.9), and in fact undue reliance on such an approach could create a significant burden for taxpayers. Thus, these Guidelines do not require either the tax examiner or taxpayer to perform analyses under more than one method*". In addition, we see a particular risk that the workload on taxpayers is significantly and unnecessarily increased if tax authorities are invited to demand increasing levels of information which may not be readily available and are irrelevant.

25. In this context, §3.2.1.1.2 of the Handbook does not appear relevant in view of the OECD methods. No preference for particular methods should be advocated in this Handbook.

Specific observations on Section 3 of the Handbook

26. One of the main interests of the Handbook lies in the factors and indicators that suggest to the tax administration that TP risk may be high with regard to a particular taxpayer. Those are described in section 3of the Handbook "assessing when transfer pricing risk exists and when it does not":

- ✓ 27. The Handbook highlights that pricing discrepancies may suggest a high level of TP risk and consequently determine that a thorough audit is necessary. We agree with the Handbook that pricing discrepancies could be one risk factor (§38) but only in the framework of the CUP method if there is no justification for such pricing discrepancies. Besides the CUP method, it has to be borne in mind that some pricing discrepancies could be driven by other transfer pricing methods used by companies. For instance, should the resale minus method be implemented and resale prices be different depending on the products sold or on the entity purchasing the products for local resale, discrepancies in the transfer prices will be fully justified and should not be seen as a sign of a "risk".

- ✓ 28. As outlined in §45, "*insufficient compliance effort*" is one indicator of risk in transfer pricing. What remains to be emphasized here is the meaning of "compliance effort". What is an insufficient compliance effort ? What is a sufficient compliance effort ? The Handbook does not provide a definition of such a concept which seems rather subjective when assessing transfer pricing risk. In addition, compliance effort assessment highly depends on the local legislative environment (for instance, existence of a documentation requirement) or size of the MNE.

- ✓ 29. Tax administrations tend to expect same transfer prices among competitors. As a matter of fact, competitors can enjoy dissimilar business organizations in respect of allocation of functions and risks among the group entities. Although evolving in the same market, their market positioning, allocation of the functions over the value-chain, etc. may differ as may their pricing. It may be therefore shortsighted to compare the company under review's profitability to industry standards. Low profits by comparison to industry standards are not conclusive evidence of mispricing. In addition, comparison can only be made with non-related parties so, it will often prove difficult to make a comparison within an industry. We therefore question the relevance of such a comparison and the notion of industry standards *per se*.

- ✓ 30. Similarly, when examining potentially comparable companies, we would like to draw attention to the accuracy of these comparisons. On this point, we note that the five comparability criterion mentioned by the OECD should be taken into account by tax authorities to reach reliable comparable data.

- ✓ 31. §62 introduces an additional factor of risk for MNEs: "recurring losses / losses over a period of years". The Handbook acknowledges the fact that "*losses over a period of a few years might be justified under the arm's length principle*". It could also be added that, by definition, a loss position is not a "risk factor" for the entity considered as "the entrepreneur". Losses may only be a "risk factor" for routine entities should a comparison with the situation between non-related parties establishes that such losses are not arm's length.

- ✓ 32. With regard to the transfer of intangibles to related parties or use of the same by related parties, the Handbook is in line with the above as only considering the significant profit deriving from intangibles. However, much here depends on the development of the business. In other words, intangibles could also lead to significant losses. We recommend that the necessary clarifications are inserted to correct this shortcut.

- ✓ 33. According to the Handbook, transfer pricing risk could arise from business restructuring. "*Often these transactions involve efforts to move valuable assets into more tax-favoured environment*". Presumption of tax optimization from the taxpayer is again involved here, which is not compliant with Chapter IX of the OECD Guidelines.

- ✓ 34. Section 3 eventually concludes with an executive summary of the guidance set out in the main text which should act as a practical checklist of issues to consider in a transfer pricing risk assessment. The checklist (both in Sections 3 and 4) should be reviewed to ensure its consistency with the main body of the text since certain differences exists (for instance, while the report suggests a transfer pricing risk when continuous losses exist, the practical checklist only provides "loss making").

- ✓ 35. Finally, since one of the purposes of the Handbook is to help tax authorities assess whether a transfer pricing audit should be commenced or not (§13), we would have expected a more detailed analysis of the facts suggesting a low level of transfer pricing risk (Section 3.2.4). In this regard, §88 listing certain situations suggesting a low level of risk could include comments on the existence of formal or informal safe harbours (e.g., the general acceptance of limited mark-up rates for services with low value added invoiced according to a cost plus method).

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