C/M/S/ Bureau Francis Lefebvre

memorandum

à / to Mr. Jeffrey Owens – OECD, Centre for Tax Policy and Administration

cc

de / from Stéphane Gelin, Bruno Gibert, Arnaud Le Boulanger

date January 8, 2010

objet / re **Comments on the proposed revision of Chapters I-III of the Transfer Pricing Guidelines**

Dear Sir,

Please find hereafter some comments on the discussion draft issued by the OECD on September 9, 2009, regarding the proposed revision of Chapter I-III of the Transfer Pricing Guidelines.

We would like to take this opportunity to express the great value that we attach to the work of the OECD and of Working Party No. 6 of the Committee of Fiscal Affairs in designing, promoting and enhancing Transfer Pricing Guidelines in a manner that aims at achieving balanced and harmonised rules and at enabling Multinational Enterprises and, more generally, the business community, to apply them in an efficient and practical way.

The transfer pricing experts of CMS Bureau Francis Lefebvre are at your disposal should you need us to further develop these comments or provide additional background or information.

Yours sincerely.

C/M/S/ Bureau Francis Lefebvre

COMMENTS ON THE PROPOSED REVISON OF CHAPTERS I-III OF THE TRANSFER PRICING GUIDELINES

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Do you authorize the OECD to publish your contribution on the Internet site www.oecd.org/taxation?

■ Yes

Experts of the Transfer Pricing Group of CMS Bureau Francis Lefebvre who contributed to these comments are:

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Chapter I - The Arm's Length Principle

As a foreword, we welcome the fact that the proposed draft adds more flexibility and more pragmatism to the wording of a significant number of paragraphs. We believe that most of these wording amendments will enhance the ability for taxpayers and practitioners to apply these Guidelines in a manner which complies with their spirit and key principles, while being able to better adapt to actual and factual situations.

Some specific sections or paragraphs of the revised Chapter I call for additional comments.

B. Statement of the arm's length principle

§1.6 to §1.15 We welcome the emphasis made on the concept of reasonableness in the Guidelines, specifically when it applies to the estimate of an arm's length outcome, to the reliability of information and more importantly to the reliability of comparables. Yet, this emphasis is made as a general statement in §1.13 dealing with the arm's length principle. It would be helpful that such concept be reminded in the developments dealing with comparability factors (§1.33 to §1.62) and comparability analysis (Chapter III). It appears in some instances there that the standard for comparability is placed at a very demanding level, which is not very consistent with the reasonableness approach.

C. A non-arm's-length approach: global formulary apportionment

§1.16 to §1.32 We welcome the transfer of the discussion on global formulary apportionment under Chapter I as opposed to new Chapter II; indeed, a method which is deemed not to be acceptable should not be discussed under Chapter II. Would it make sense to extend to the CCCTB (Common Consolidated Corporate Tax Base) approach the conclusion that global formulary apportionment is not an arm's length method?

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D. Guidance for applying the arm’s length principle

§1.38 The last sentence of this paragraph (stating that if it can be reasonably assumed that despite some pieces of information being missing, the uncontrolled transaction at issue is a reasonably reliable comparable, the comparison should not be rejected just because of the limitations on the availability of information) is highly welcome. As stated above, however, it would be very helpful that the OECD attempts broadly defining what a “reasonably reliable comparable” is in practice, be it in Chapter I or in the new Chapter III on Comparability Analysis. We believe this could be a “relative” definition, for instance formulated around the notion that a comparable (or set of comparables) is to be regarded as reasonably reliable unless it can be shown that more reliable comparables could easily be

obtained with an amount of effort which is not disproportionate in the case at hand.

§1.40 This paragraph discusses the fact that the requirements for comparability of property or services differ depending on the transfer pricing method. We agree with this statement. However, when stating that "this (…) does not mean that taxpayers can ignore the question (…)", this paragraph should add "and tax administrations" after the word "taxpayers". Indeed, we believe that the principles stated in this paragraph should apply in the same manner to all parties at stake.

§1.43 This paragraph states that adjustments "should be made for any material differences from the functions undertaken by any independent enterprises with which (the party under examination) is being compared". We believe that, since this paragraph is stating a general principle here, which seems to apply to all situations, the OECD should better define the notion of "material differences" used here, probably in reference to the definition of a comparable transaction provided in §1.33, i.e. a difference that "could materially affect the condition being examined in the methodology (e.g. price or margin)".

§1.44 At the end of this paragraph, which states that the functional analysis should take into account the types and nature of assets used, we would recommend that the OECD adds: "to the extent to which this information is publicly available." Indeed, it is our experience that this type of information is rarely available (even for "internal comparables"), or is available in only very broad terms, when the independent party owning or using the assets is not itself a member of the taxpayer's group.

§1.58 This paragraph discusses business strategies. While we generally agree with the statements of this paragraph, we recommend that the OECD adds, at the end of it, that in practice the types of information discussed here are often not publicly available for independent parties, and therefore that a lack of publicly available information on business strategies regarding a comparable (or set of comparables) should not prevent from considering it a "reasonably reliable comparable" (in reference to §1.38).

§1.77 to §1.78 We believe that, after these paragraphs on the use of customs valuation, the OECD should encourage efforts towards the harmonization of the valuation regulations from a transfer pricing and a customs standpoint, for instance in such areas as the acceptability and treatment of retroactive price adjustments, as well as the possibility to obtain joint Advance Pricing Agreements from both tax and customs administrations.

Chapter II - Transfer pricing methods

As a preliminary remark, we regret that the proposed revision of the Transfer Pricing methods chapter does not address the "Entrepreneur" concept. Only the "tested party" is referred to, with an indication that entities that are comparable to it might be sought for.

Still, in practice, both tax authorities and taxpayers often try and identify the "Entrepreneur" while examining inter-company transactions, as a cornerstone to method selection. In these practical approaches, the Entrepreneur is usually the party, in the controlled transaction, that performs the most complex, value adding or strategic functions, and/or bears the most significant business risks, and/or own the most differentiating or strategic assets. It is often admitted that one should not use a transfer pricing method that would set the margin of the Entrepreneur (when only one of the parties to the controlled transaction satisfies the above criteria), or, if it is so, only with specific care. Indeed, the choice of a method should usually lead to allocating the residual profit (or loss) to the Entrepreneur, when economic conditions fluctuate.

Therefore, explicitly referring to this concept, and defining, in the OECD Guidelines, the Entrepreneur's main roles and responsibilities, might be useful.

Some specific sections or paragraphs of the revised Chapter II call for additional comments.

Part I: Introduction

A. Selection of the most appropriate transfer pricing method to the circumstances of the case

§2.7 We welcome the good practice indication as regards transfer pricing method selection, consisting in selecting and evidencing the most appropriate method and comparables, and not in analysing in depth or testing in each case all the transfer pricing methods.

B. Use of more than one method

§2.10 We also welcome the assertion that the application of more than one method for a given transaction is not required, which shows that our last comments have been taken into account so far.

Part III: Transactional profit methods

B. Transactional profit split method

§2.87 to §2.93 We welcome the guidance for applications of the transactional profit split method, which is a good initiative and are really helpful. Still, as far as allocation keys are concerned, we regret the emphasis made on allocation keys based on assets or on costs, which leads to implicitly deem less reliable other allocation keys. Indeed, we would find it appropriate to refer to an

allocation key that is based on both assets and costs, or to an allocation key that is based on functions performed and risks borne by each entity at stake. Functions and risks are the cornerstone of any functional analysis and should not be ignored in the framework of the application of the transactional profit split method. Furthermore, functions and risks may be attributed a relative value as this is possible for assets (§2.90). Finally, we find the allocation keys suggestions still incomplete at this stage.

§2.94 We welcome the reference to joint-venture arrangements between unrelated parties as a possible source of comparable *uncontrolled* transactions. This gives a useful theoretical basis to our discussions with some tax authorities (that sometimes regard transactions with joint-venture entities as controlled transactions).

Part III: Transactional profit methods

C. Transactional net margin method

§2.108 The end of this paragraph states that, when using the transactional net margin method, "it is not the case that non-unique functions should be remunerated differently depending on the profitability of the group as a whole". We agree with this statement and we welcome the amendments made to clarify this point. We however would have appreciated more flexibility for the analysis, considering that, when using the transactional net margin method, the group's financial health may not always be completely ignored. On the open market, even for a routine function, it is not rare that a firm accepts to revise its price conditions with one of its suppliers or customers for a while in order to maintain a long term relationship. In this way, it should be reminded that, if one should still consider an arm's length range of results whatever method is used, the profitability of the group as a whole may, in some cases, be one of the factors to be considered when determining which point within the range best reflects the facts and circumstances of the particular controlled transaction.

§2.112 This paragraph states that "the transactional net margin method may be more sensitive than the cost plus or resale price methods to differences in capacity utilisation, because differences in the levels of absorption of indirect fixed cost" (this notion is illustrated in the ANNEX II of the draft). We disagree with this statement, and believe that the statement should at least be balanced with the fact that net margins are less sensitive than gross margins to differences in volume. Indeed, it is common economic knowledge that independent parties shall negotiate different pricing or gross margins conditions, depending of the volumes at stake. Similarly, too "blind" a use of the gross margin observed in an uncontrolled transaction, when volume is not

similar, may quickly lead to an extraordinarily high or low actual net profit for the related party which the gross margin is thus set, leading to very inconsistent results. On the contrary, it is our experience, observing results of numerous companies in various industries, across many years, that by and large net margins are fairly aligned in a given industry for a given type of activity, irrespective of the size of the company, showing that net margins are significantly less affected than gross margins by volume differences. Besides, we are also concerned about the fact that such assertion could lead to erroneous interpretation or add difficulties to apply the Guidelines. Firstly, it may imply that, when testing the remuneration of a tested party which is in an overcapacity situation, its net margin (and not transfer prices) should be adjusted to take into account capacity utilisation and therefore legitimate the fact that the tested party bears the whole under-activity risk, which in practice should not necessarily be the case. Secondly, the capacity utilisation could thus be considered as an additional comparability criteria when searching for comparables, whereas in practice such information is often not publicly available for independent parties. We would therefore recommend adding some safeguards to this statement or simply deleting it.

§2.121 This paragraph states that "interest income and expenses other than with respect to trade receivables and payables should generally be excluded when applying the transactional net margin method to non-financial transactions". We would recommend also considering interest expenses related to inventory financing as a financial item that may be included in the net profit, as also correlated to the operating activity.

§2.141 This paragraph discusses the conditions under which the Berry ratio would be appropriate to test the remuneration of a controlled transaction. One of these conditions is that "the value of the functions performed in the controlled transaction […] is not materially affected by the value of the products distributed, i.e. it is not proportional to sales". While, in practice, the Berry ratio is often used for testing the remuneration of a commissionaire activity, as the lack of information on independent agents' generated turnover does not allow analysing their remuneration in a percentage of a turnover, such condition excludes the use of the Berry ratio for commissionaire functions. We believe that this condition should be deleted.

Chapter III - Comparability analysis

By way of introduction, we noticed that numerous elements are proposed to be added in this section providing taxpayers and administrations with more complete guidelines for the selection of comparables and therefore increasing the taxpayers' security in the course of an audit. We highly welcome these enhancements to the Guidelines.

Some specific sections or paragraphs of the revised Chapter III call for additional comments.

A. Performing a comparability analysis

§3.2 Regarding the difficulty to identify appropriate comparables, we appreciate that it is explicitly admitted that "reasonable efforts" should be made to select "reasonably reliable comparables". As a result, searches for comparables do not aim at identifying perfect comparables. However, we anticipate that the assessment of how reasonable the efforts are or how reasonably reliable the comparables are could prove to be difficult in practice. As a consequence, we recommend that the concepts of "reasonable efforts" and "reasonably reliable comparables" be more detailed.

§3.4 We welcome the obligation to implement a transparent process for the selection of comparables which will apply both for taxpayers and tax administrations.

§3.10 We also welcome the explicit reference to portfolio approaches since in practice such approaches are often used by MNEs and challenged by tax administrations.

§3.25 It is good practice to remind that in a “risk assessment phase” taxpayers' controlled transactions must be compared to other taxpayers' controlled transactions. However, if information on other controlled transactions might be useful in the risk assessment phase, the risk assessment phase itself should be clearly defined. Besides, the Guidelines should stress out that the comments made in this paragraph do not imply that other taxpayer’s controlled transactions may be relied upon when it comes to setting transfer prices for the controlled transactions under examination, which would be contrary to the very purpose and definition of the arm’s length principle.

§3.26 We welcome the admission of minority shareholders as a factor leading transactions to be closer to arm's length conditions in certain circumstances.

§3.28 Even if we agree that internal comparables as well as external comparables should ideally satisfy the five comparability criteria, we regret that the guidance do not draw the obvious consequence from the difficulty to find perfectly comparable transactions or enterprises. Moreover, this obligation disallows taxpayers to limit their work to the identification of "reasonably reliable comparables". We recommend that point 3.28 does not refer to the

five comparability criteria but only addresses three of them, being the easiest (or, rather, less difficult) ones to check in practice, i.e. functions, assets, and risks.

vii) Arm's length range

We noticed that this section mixes up the arm's length range and the comparability while these concepts are different. Comparables selected must comply with the comparability criteria. Based on these comparables, an arm's length range should be defined to assess whether the taxpayer's prices or margins are arm's length. As a result, non comparable transactions or companies should be eliminated during the search for comparables. The range should not be refined because of the lack of comparability of the selected comparables. We therefore recommend to replace "while every effort has been made to exclude points that have a lesser degree of comparability" (§3.56) with "while every effort has been made to exclude non-comparable transactions during the search process".

For that reason we expect that all points contained within the range should be accepted if the search process was reliable (§3.62).

§3.61 This paragraph states that "where comparability defects remain as discussed at §3.56, it may be appropriate to use measures of central tendency". In their current state the revised Guidelines do not define what is meant here by central tendency, nor mention the very important concept of central dispersion. As a consequence, we generally do not agree with this statement and believe that, in its current wording, it may lead to difficulties in interpreting and implementing the revised Guidelines. As mentioned above, it is most often not possible to identify perfect comparables. On the basis of this paragraph, tax administrations would be able to reassess any taxpayer's revenue in the course of an audit, by claiming that comparability defects remain (which in practice will always be the case) and therefore that only the measure of central tendency (i.e. median of a range) is acceptable, even when that taxpayer used a transfer price (or margin) in the arm’s length range, but not the median. Besides, when a transfer price is observed to fall out of the arm’s length range, this would in effect always provide justification to tax administrations to use medians when reassessing the taxable income, while in practice other points in the range may be as well suited for this. Finally, and even more importantly, it would ultimately question the very concept of an arm's length range: On the contrary, we would appreciate that the guidance explicitly reminds that, following a reliable search process, only reasonably reliable comparables have been selected, and therefore that the whole arm's length range provides a reliable approximation of the workings of the open market (even in the course of an audit). Still, the Guidelines could signal that, in practice, the full range of observations is often refined with a measure of central tendency *and dispersion*, for instance using statistical tools such as

medians *and interquartile ranges*. We believe that such a statement would better reflect the practice used, to our knowledge, by many taxpayers and agreed by a number of tax administrations in Advance Pricing Agreements.