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12 May 2006

Dear Madam,

Comments on Transactional Profit Methods

We are responding to the invitation to comment on Transactional Profit Methods and the paper circulated by the OECD [last month]. In this letter we comment on three issues which we consider to be particularly important. We include as an attachment a more detailed response to the various issues in the format of your original paper.

Issue 1. Status of transactional profit methods as last resort methods

We believe that the transactional profit methods should be given the status of an equally acceptable alternate method rather than a transfer pricing method of last resort.

We reach this conclusion because, in practice, there are now many instances where a transactional profit method is the method of first choice. In a world where brand values and intellectual property are becoming increasingly important and where the functions of group entities are highly integrated, we can no longer rely on the traditional transaction methods.

There are many cases where the traditional transaction methods are just not appropriate. It is difficult to find true comparable uncontrolled prices in many cases due to brands / intangibles. The Cost Plus Method also has limited application to services and is not applicable for services involving creating, enhancing or using intellectual property. Similarly, where significant value is added by an entity, it is not advisable to apply the Resale Price Method. Therefore, in many cases, it is only the transactional profit methods that are applicable.

In summary, we recommend that the transactional profit methods should not be treated as methods of last resort.

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Issue 5. Documentation and the need / desire of tax administrations to have access to information worldwide

The requirements to maintain excessive documentation to support intra-group transfer prices is burdensome for taxpayers and adds no value to them other than helping them avoid or mitigate tax penalties. This burden has increased significantly in recent years as the decisions in non-discrimination cases before the ECJ have meant that such requirements have been extended to wholly domestic transactions where even tax authorities have no interest in making adjustments. Devoting skilled time and effort to creating vast amounts of documentation that are only required for intra-group transactions and are not required for third party transactions, is not furthering the economies of the OECD member countries and so should be reduced as much as possible.

For these reasons we believe that the current EU initiative to standardise and reduce documentation requirements is to be encouraged and minimal standardised documentation should similarly be adopted by the OECD.

Issue 11. Other methods and consideration of global formulary apportionment methods

We are in favour of retaining the freedom to apply other methods. Business is constantly changing. Today's big businesses may not be tomorrow's and the ways in which companies transact with one another today may be completely different tomorrow as technology and sophistication increases even further. Changes occur faster than either governments or the OECD can react to them. Consequently, maintaining flexibility in the guidelines is essential.

As a separate point, we are no longer in favour of the explicit rejection of global formulary apportionment methods as stated in paragraphs [3.58 to 3.74] of the 1995 Transfer Pricing Guidelines. Stated simply, we believe that businesses want certainty and administrative simplicity. They will accept any method of apportioning profits between tax jurisdictions provided it is easy to administer and they can budget for the consequences and accurately forecast the group's final profits and tax liabilities.

Elevating the status of the transactional profit methods to equal status with the traditional transaction methods is essentially a move towards formulary apportionment as profit split methods are, by their nature, dependent on the application of specific formulae.

We do not consider that the concept of formulary apportionment should be rejected as a matter of principle and we believe that it should be able to be applied in circumstances where such a method is agreeable to member countries. It may be, for example, that EU countries eventually agree the terms of a formulary apportionment method that may be used by specific industrial sectors. In such circumstances, we would like such a method to be available for use by groups with trading operations in the EU.

In addition to the certainty of taxation, the other big benefit to businesses of adopting a formulary apportionment methodology is that it reduces the burden on businesses of justifying its transfer prices and the need for detailed functional analysis. The cost of compliance is therefore very much lower.

We think a discussion of the factors to be used as part of any formulary apportionment method is beyond the scope of this letter, but we do feel that the principle of considering such methods as acceptable is an important issue that should be given serious consideration by the OECD.

We would be pleased to discuss any issues raised by this letter in more detail if that would be helpful.

Yours sincerely

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COMMENTS ON TRANSACTIONAL PROFIT METHODS

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

Yes

No

LIST OF ISSUES CONSIDERED (our comments are in **bold** below)

Issue 1 – Status of transactional profit methods as last resort methods

DESCRIPTION: In the 1995 TP Guidelines, traditional transaction methods are regarded as preferable to other methods (see paragraphs 2.49 and 3.49 of the Guidelines). Transactional profit methods are described as last resort methods the use of which should be limited to those exceptional situations where there are no data available or where the available data are not of sufficient quality to rely solely or at all on the traditional transaction methods.

Please comment on:

- Whether you consider that the status of transactional profit methods as last resort methods is appropriate or whether you consider that this status should be revisited, and if so why. Please respond separately for the profit split methods and for the transactional net margin method.

We believe that the transactional profit methods should be given the status of an equally acceptable alternate method rather than a transfer pricing method of last resort.

We reach this conclusion because, in practice, there are now many instances where a transactional profit method is the method of first choice. In a world where brand values and intellectual property are becoming increasingly important and where the functions of group entities are highly integrated, we can no longer rely on the traditional transaction methods.

There are many cases where the traditional transaction methods are just not appropriate. It is difficult to find true comparable uncontrolled prices in many cases due to brands / intangibles. The Cost Plus Method also has limited application to services and is not applicable for services involving creating, enhancing or using intellectual property. Similarly, where significant value is added by an entity, it is not advisable to apply the Resale Price Method. Therefore, in many cases, it is only the transactional profit methods that are applicable.

In summary, we recommend that the transactional profit methods should not be treated as methods of last resort.

- Would your response to this question differ depending on whether the transfer pricing method is used to set the arm's length price of future transactions, or to test the outcome of already completed transactions at the year end or during an audit?

The fact whether the transfer pricing method is being used to set the arm's length price of future transactions or to test the outcome of already completed transactions or during audit should not affect the choice of methods in theory, although in practice where only operating margin data is available to test prior year transfer pricing results it can be helpful to use this benchmark to set a forward looking gross margin (RPM) target for the same sales function. Further, in case of setting arm's length prices of future transactions, it is advisable to undertake an exhaustive search for possible Comparable Uncontrolled Prices ('CUPs') and to carry out a Transactional Net Margin Method ('TNMM') analysis for corroborating the traditional transaction methods in case they were used as a primary method.

- Whether you consider that the use of transactional profit methods is particularly appropriate for specific industries / activities / transactions / business models and if so for what industries / activities / transactions / business models and for what reasons. Would you consider that there are specific industries / activities / transactions / business models for which the status of transactional profit methods as last resort methods should be reviewed? Would you consider that for those specific industries / activities / transactions / business models the transactional profit methods should be placed at the same level as the traditional methods (excluding CUP)? To the extent relevant please respond separately for the profit split methods and for the transactional net margin method.

The Profit Split Method is often applicable in global trading scenarios and where distributors have valuable intellectual property ('IP'). TNMM is usually good where Cost of Goods Sold ('COGS') is accounted inconsistently, e.g. in case of services or if gross profit information is not available.

- Whether you regard the use of transactional profit methods as an appropriate solution to situations where there are no comparable data available or where the available comparable data are not of sufficient quality to rely solely or at all on the traditional transaction methods. To the extent relevant please respond separately for the profit split methods and for the transactional net margin method.

In case there is no reliable gross margin data available, it is advisable to use the transactional profits method.

- Any other remark you may have in relation to the hierarchy of methods in the 1995 TP Guidelines.

Issue 2 – Use of a transactional profit method either in conjunction with a traditional transaction method or as a sanity check to test the plausibility of the outcome of a traditional transaction method.

DESCRIPTION: The 1995 TP Guidelines do not require the application of more than one method and indicate that it will generally be possible to select one method that is apt to provide the best estimation of an arm's length price. However, for difficult cases, where no one approach is conclusive, a flexible approach would allow the evidence of various methods to be used in conjunction. In such cases, an attempt should be made to reach a conclusion consistent with the arm's length principle that is satisfactory from a practical viewpoint to all the parties involved, taking into account the facts and circumstances of the case, the mix of evidence available, and the relative reliability of the various methods under consideration (see paragraph 1.69 of the 1995 TP Guidelines).

In addition, practical experience acquired by taxpayers and tax administrations since the TP Guidelines were approved in 1995 shows that in some cases a transactional profit method (profit split or transactional net margin method) is applied either by the taxpayer or by the tax administration to test the plausibility of the outcome of a traditional transactional method that is used as the primary transfer pricing method, for instance where the results of applying a traditional method are uncertain.

Comments are invited on:

- Situations where the use of a transactional profit method in conjunction with a traditional method is found helpful or necessary, for what reasons, and how this can work in practice. Please respond separately for the profit split methods and for the transactional net margin method to the extent relevant.

TNMM is always good for corroborating gross margin benchmarking. The variant of the Comparable Profits Method should be allowed where there are several interlinked or offsetting transactions and have to be benchmarked in isolation, for example, sale of goods and maintenance contracts. Due to differences in the manner of accounting treatment, certain expenses could be accounted for at gross level by a company and at the operating level by another company. To iron out such differences, it is always advisable to corroborate gross margin benchmarking with operating margin benchmarking.

- Situations where the use of a transactional profit method to test the outcome of a traditional method is found helpful or necessary, for what reasons, and how this can work in practice. Please respond separately for the profit split methods and for the transactional net margin method to the extent relevant.

Issue 3 – Application of transactional profit methods and intangibles

DESCRIPTION: Transactional profit methods are regarded as particularly useful in those cases where valuable or unique intangibles are used by each party to a controlled transaction because these are the cases where traditional methods are the most difficult to use. There is however limited guidance in the 1995 TP Guidelines on how transactional profit methods help taking into account the use of intangible assets in a controlled transaction. Comments are invited on:

- What the situations involving intangibles are where a profit split or transactional net margin method would be particularly useful,

In cases where the activities of the related parties are highly integrated (like a global trading model) a total profit split is usually applied. Here, the combined profits, which are the total profits from the controlled transactions under examination, would be divided between the associated enterprises based upon the relative value of the functions performed by each of the associated enterprises participating in the controlled transactions, supplemented as much as possible by external market data that indicate how independent enterprises would have divided profits in similar circumstances.

In cases where the related parties undertake some routine functions and also are jointly responsible for developing and/or owning intangibles, the residual profit split method would be the most applicable. Under this method, the parties would be appropriately rewarded for their routine functions (using a traditional transactional method or a transactional profit method) and the residual profit (loss) can be then divided between the parties in proportion, for example, to the development / maintenance costs that they bear with respect to the intangible.

In case the intangible property is licensed by an entity to another related party, and there is no internal or external CUP available, it could be appropriate to use a TNMM method to test the arm's length nature of the royalty paid for the intangible property, as the royalty paid would form part of the cost base of the tested party and hence get automatically tested for its compliance with the arm's length principle. This would be equivalent to a profit split method where 100% of the super profit is allocated to the economic owner of the intangible asset.

- How a profit split or transactional net margin method may help taking into account the intangibles used in the controlled transaction.

Issue 4 – Application of transactional profit methods and consideration of risks

DESCRIPTION: The importance of properly identifying the risks assumed by the parties as part of the functional analysis is highlighted at paragraphs 1.23 to 1.27 of the 1995 TP Guidelines. In practice there are issues in relation to the identification of risks and of the parties that assume, manage and bear the risks; valuation and determination of an arm's length reward for risks management and risk bearing; and assessment of an arm's length allocation of risks among the parties. A consideration of risk is found to be usually crucial in the application of the transactional profit methods. Comments are invited on how transactional profit methods can take into account the consideration of risks associated with a controlled transaction. Examples of pricing scenarios where the risk factor is of significance would be very helpful.

Consideration of risk factors is specially important in case of transactions involving development of new products/processes/markets etc. The development, ownership, exploitation and maintenance of intangible assets entail substantial risks and merit an appropriate share of returns. In case of joint development and ownership of intangible assets, it is therefore suggested to use a (residual) profit split method as the super profits or losses normally accrue to ownership of intangibles. TNMM (via total cost mark-up) is good for benchmarking low risk contract/ toll manufacturers and stripped risk distributors / sales agents.

Issue 5 – The need for tax administrations to have access to all information needed to apply or review the application of a transactional profit method

DESCRIPTION: One practical difficulty encountered by tax administrations when reviewing a transactional profit method used by a taxpayer or when applying a transactional profit method in the course of an examination is the need to have access to information. There are different types of issues:

- The need to obtain information of an analytical or managerial nature that goes beyond the classical legal requirements (for instance, information from cost accounting systems),
- The need to obtain information on a foreign related party where the extent of the functions, risks and assets of the foreign party would have affected the compensation of the transaction under examination, should said transaction have taken place between independents,
- The need to obtain information on a foreign related party where the transfer pricing method applied necessitates information on the foreign party's functions, assets and risks (e.g. where a transactional net margin method is applied to the foreign party, or in the case of a profit split where both detailed financial information on the taxpayer and detailed financial information on the foreign related parties are needed).

Comments are invited on the extent to which these issues can be satisfactorily addressed in transfer pricing documentation requirements.

The requirements to maintain excessive documentation to support intra-group transfer prices is burdensome for taxpayers and adds no value to them other than helping them avoid or mitigate tax penalties. This burden has increased significantly in recent years as the decisions in non-discrimination cases before the ECJ have meant that such requirements have been extended to wholly domestic transactions where even tax authorities have no interest in making adjustments. Devoting skilled time and effort to creating vast amounts of documentation that are only required

for intra-group transactions and are not required for third party transactions, is not furthering the economies of the OECD member countries and so should be reduced as much as possible.

For these reasons we believe that the current EU initiative to standardise and reduce documentation requirements is to be encouraged and minimal standardised documentation should similarly be adopted by the OECD.

Issue 6 – Application of a profit split method: determination of the profit to be split.

DESCRIPTION: There is currently limited guidance in the 1995 TP Guidelines on how to determine the profit to be split under a profit split method. Paragraph 3.17 indicates that "[g]enerally, the profit to be combined and divided under the contribution analysis is operating profit. [...] However, occasionally, it may be appropriate to carry out a split of gross profits and then deduct the expenses incurred in or attributable to each relevant enterprise (and excluding expenses taken into account in computing gross profits)."

Comments are invited on the following issues:

- What measure of profit can be used in the absence of harmonised tax accounting standards? Can the profit to be split be determined according to financial accounting?

In the absence of a harmonised tax accounting standard, it seems safest to use a PBITD (Profit before interest, tax and depreciation) excluding exceptional items for splitting between the related parties. If it is believed that consistent depreciation policies are used, then PBIT may be more appropriate for capital intensive industries.

- In what cases should net, operating or gross profits be used in a transactional profit split method?

In the case of an MNE that engages in highly integrated worldwide trading operations, involving various types of property, it may be possible to determine the enterprises in which expenses are incurred (or attributed), but not to accurately determine the particular trading activities to which those expenses relate. In such a case, it may be appropriate to split the gross profits from each trading activity and then deduct from the resulting overall gross profits the expenses incurred in or attributable to each enterprise, bearing in mind the caution noted above.

If the countries in question are following the same GAAP, we can safely consider a gross profit split. A gross profit split is simple to administer specially when foreign countries are involved because the expenses move up and down with the movement in the foreign currencies. Having said that, it is advisable to use the operating profit before interest, tax and depreciation for further split.

Net margins (after interest) should never be used.

- Where a net margin is used, how is it defined? What are the expenses that should be treated as above or below the line? Does the response to this question differ depending on the functional analysis of the parties, e.g. on which party is responsible for what costs?

In transfer pricing context, by net margin we normally understand net operating margin, i.e. net income from the chief operations of the company.

Whether an expense should be treated as operating or non-operating depends on the business of the enterprise. For example, income from investments and interest on financing activities would be non-operating for a manufacturing entity. However, these are operating in nature for an investment or a banking company.

Where operating profits are used, how to ensure that both income and expenses are attributed to the relevant associated enterprise on a consistent basis? How to identify the appropriate operating expenses associated with the transactions and to allocate costs between the controlled transactions under review and the associated enterprises' other activities?

The functional analysis of the related parties should help in identifying the income and expenses attributable to the relevant party. Verification of accounts which is done during an audit, should help sufficiently in identifying the appropriate operating expenses associated with the transactions. The allocation of costs between the transactions and the associated enterprises' other activities could be based for example on the proportion of the total sales vis-à-vis the related party sales.

- Where gross profits are used, how to ensure that the expenses incurred in or attributable to each enterprise are consistent with the activities and risks undertaken there, and that the allocation of gross profits is likewise consistent with the placement of activities and risks?

Since we use the audited accounts for our purposes, the fact that the expenses incurred in or attributable to each enterprise are consistent with the activities and risks undertaken there should be taken care of (to the extent that material transfer pricing exposures were identified by the auditors and acted on by the company). Further, while a benchmarking, the tested party is usually compared with comparable companies within the same jurisdiction. Hence, accounting inconsistencies should not be an issue. However, if for example, we are conducting a pan-European or an Asian search, where there could be differences in the accounting treatment between the countries involved, it is advisable to consider net operating margins rather than the gross margins.

Issue 7 – Application of a profit split method: reliability of a residual analysis and of a contribution analysis

DESCRIPTION: The 1995 TP Guidelines recognise that, when applying a transaction profit split method, there are a number of approaches for estimating the division of profits, based on either projected or actual profits, as may be appropriate, that independent enterprises would have expected. Two of these possible approaches -- contribution analysis and residual analysis -- are discussed in Chapter III of the 1995 TP Guidelines.

Comments are invited on:

- Whether there are cases where a residual analysis is more reliable or appropriate than a contribution analysis and if so why

The residual profit split analysis is particularly useful when both the related parties own and contribute to the development and maintenance of non-routine intangibles, and carry out distinct routine operations.

- Whether there are cases where a contribution analysis is more reliable or appropriate than a residual analysis and if so why.

A contribution analysis is more appropriate when the related parties not only jointly own or develop non-routine intangibles but their operations are also highly integrated on a routine basis. For example, if in a group, there are four entities in four jurisdictions, each undertaking research, development, production and sale of products, within and outside their jurisdiction, for products produced by themselves as also their overseas related party. This is a truly integrated global trading operation and we could do best by undertaking a contribution analysis for each enterprise.

Whether other types of approaches should be considered and if so in what cases and how they would apply.

Issue 8 – Application of a profit split method: how to split the profit

DESCRIPTION: Once the profit to be split is identified, a profit split method seeks to split the profit between the associated enterprises on an economically valid basis that approximate the division of profits that would have been anticipated and reflected in an agreement made at arm's length. The allocation of profit is based on the division of functions between the associated enterprises. External data from independent enterprises are relevant in the profit split analysis primarily to assess the value of the contributions that each associated enterprise makes to the transactions, and not to determine directly the division of profit. (See paragraphs 3.5 and 3.6 of the 1995 TP Guidelines).

As acknowledged at paragraph 3.18 of the 1995 TP Guidelines with respect to the contribution analysis, "[i]t can be difficult to determine the relative value of the contribution that each of the related participants makes to the controlled transactions, and the approach will often depend on the facts and circumstances of each case. The determination might be made by comparing the nature and degree of each party's contribution of differing types (for example, provision of services, development expenses incurred, capital invested) and assigning a percentage based upon the relative comparison and external market data."

Comments are invited on:

- The relevance in practice of external data to support the division of profits under a profit split method,

External data, in the absence of an internal CUP, is particularly relevant while applying the residual profit split.

- How external data are used in profit split analysis and how they enhance the reliability and objectivity of the analysis,

External databases are used to arrive at the routine margins of the comparable companies. Further, they can be used indirectly to support profit splits, for example: a) research into how profits from intellectual property ('IP') are split between the licensor and licensee; b) regressions of profit margins on IP development spend, example R&D intensity.

- The reliability and objectivity of a profit split analysis that does not rely at all on external data,

Profit splits that do not rely on external data are not very reliable. Since external data is the publicly available data, sourced from audited accounts that are filed with the registrar of companies (equivalent of the Company House in the UK), it usually is a very reliable data. In

case there are suitable CUPs available, they can certainly be used as the benchmark reward for the routine activities performed by the related entities.

- How to determine the relative value of each party's contribution to the controlled transaction under review,

The relative value of each party's contribution to the key profit generating activity or asset can be based on a benchmarked return to their investment in the relevant intangible asset, for an instance, or on market information on how the super-profits arising from the application of an intangible asset are split between the owner and the licensee. For example, the value of contributions to IP can be measured by relative R&D or strategic marketing and advertising spend or headcount.

However, this is a very subjective issue and the answer really depends on what the transfer pricing analysis shows to be a key value adding function in the company's supply chain and in what degree.

- What allocation keys are mainly found in practice, in what cases are they suitable and what their strengths and weaknesses are,

Allocation is done normally on the basis of the critical factors involved, for example, allocations based on sales, costs, headcount, etc. are commonplace. The basic principle while deciding the allocation key is that it should be linked to the profit generating activity, easy to use and should result in an allocation of profit as close as possible to the outcome suggested by transfer pricing analysis.

- Whether different allocation keys should be used depending on whether the result to be split is a profit or a loss and if so for what reason(s).

Whether the split to be made is between a profit or a loss should make no difference to these answers.

Issue 9 – Application of the transactional net margin method: standard of comparability

DESCRIPTION: The 1995 TP Guidelines contain some discussion of the comparability standard to be applied to the transactional net margin method (see paragraphs 3.34 to 3.40). Comments are invited on the following aspects:

- Paragraph 3.34 indicates that "[p]rices are likely to be affected by differences in products, and gross margins are likely to be affected by differences in functions, but operating profits are less adversely affected by such differences. As with the resale price and cost plus methods that the transactional net margin method resembles, this, however, does not mean that a mere similarity of functions between two enterprises will necessarily lead to reliable comparisons." To what extent can a lower comparability standard be applied in a transactional net margin method than in a traditional method and for what reason(s)?

Lower comparability is allowed for TNMM compared to RPM or the Cost Plus Method because the results will not be affected by differences in operating expense ratios. The best way of adjusting for all

comparability differences is to benchmark the return on assets employed as this should only be influenced by the risk intensity of the activity.

- Experience shows that practitioners often apply the transactional net margin method by comparing the net margin earned by the taxpayer in a controlled transaction or set of controlled transactions with the company-wide net margin reported by third parties. In some other cases, it is the taxpayer's net margin that is determined on a company-wide aggregated level. To what extent do you consider the transactional net margin method can validly be applied using company-wide aggregated data (either on third party "comparables" or on the taxpayer's net margin)? To what extent can a lower standard for aggregating transactions be applied in the transactional net margin method than in a traditional method and for what reason(s)?

Company wide data can be used where functions are linked, for example, sale of goods and provision of maintenance and repair services.

Issue 10 – Application of a transactional net margin method: determination of the net margin

DESCRIPTION: As indicated at paragraphs 3.26 and 3.27 of the 1995 TP Guidelines, the transactional net margin method examines the net profit margin relative to an appropriate base (e.g. costs, sales, assets) that a taxpayer realises from a controlled transaction (or transactions that are appropriate to aggregate under the principles of Chapter I). Net margins can be for instance return on assets, operating income to sales, and possibly other measures of net profits.

Comments are invited on how to select a net margin indicator to apply the transactional net margin, in particular:

- What is a "net" margin: what are the expenses that should be treated as above or below the line? Does the response to this question differ depending on the functional analysis of the parties, e.g. on which party is responsible for what costs?

Presumably, 'net' is defined as operating profit, not profit before tax. Depreciation and amortization should probably be treated as above the line, foreign exchange gains, interest and factoring charges should be treated as below the line items.

- In what cases should the net margin be weighted against costs, sales, assets, or another base?

The denominator depends on the driver of profit, for example, sales for a distributor and perhaps assets for a manufacturer or a utility company. Further, it is recommended to use a denominator which is not affected by related party transactions.

- Where the indicator is the net margin to costs, what costs should be included in the base? In what cases would a net margin to costs be more reliable or more appropriate than a gross cost plus indicator and why?

The base should include all costs that can be classified as the operating costs, i.e. excluding income or expenses related to financing and investment activities, unless the main operation of the company is in investment or finance industry.

Net margin is more reliable when COGS are not available or where there are possible differences in the accounting principles followed by the tested party and the comparables. Also, when the tested transaction is at the operating level, operating profit margins should be analysed, while if it is at the gross level, it would be fine to compare the gross mark-up.

- How to ensure that the costs and expenses deducted from the net margin calculation are those attributable to the transaction under review?

A degree of Activity Based Costing may be needed to allocate the costs to a transaction.

- In what cases would a net margin to sales be more reliable or more appropriate than a gross resale minus indicator and why?

The gross resale minus indicator is appropriate in the case of a pure distributor, who is not carrying out much advertising or marketing or after sales services. If however, the distributor is towards the upper end of the value chain, then it would be more appropriate to analyse its operating margins in order to reward these other activities.

Fundamentally, net margins are more reliable where COGS are not reported on a consistent basis. A net margin is also better than gross margin when applying a residual profit split.

- Where the indicator is a net margin to assets, how should tangible and intangible assets be valued (market value or book value)?

Although it is most appropriate to consider the market value of assets, it could result in incomparable data as the companies could be following different depreciation policies etc. Hence, it might be a better idea to use the book value of assets while performing such analysis (assuming that the companies may follow similar policies, which is not necessarily the case cross-border). Therefore, though the assets should ideally be valued at market value, it may be unreasonable to expect that taxpayers should apply a different asset valuation approach purely for a transfer pricing exercise.

- What other net margin indicators do you consider as relevant and in what cases?

Issue 11 – Other methods

Paragraph 1.68 of the 1995 TP Guidelines indicates that multinational enterprises "retain the freedom to apply methods not described in this Report to establish prices provided those prices satisfy the arm's length principle in accordance with these Guidelines". Commentators are invited to indicate what type of other methods not described in the Guidelines might be used in practice and for what reasons.

According to existing guidance in Chapter III of the 1995 TP Guidelines "[t]he only profit methods that satisfy the arm's length principle are those that are consistent with the profit split method or the transactional net margin method as described in these Guidelines. In particular, so-called "comparable profits methods" or "modified cost plus/resale price methods" are acceptable only to the extent that they are consistent with these Guidelines." (see paragraph 3.1 of the Guidelines). In addition the same Chapter contains an explicit rejection of global formulary apportionment as a non arm's length method (see paragraphs 3.58 to 3.74 of the Guidelines). Comments are invited on the practical and theoretical differences between the OECD transactional profit methods and other methods that are regarded as not arm's length.

We are in favour of retaining the freedom to apply other methods. Business is constantly changing. Today's big businesses may not be tomorrow's and the ways in which companies transact with one another today may be completely different tomorrow as technology and sophistication increases even further. Changes occur faster than either governments or the OECD can react to them. Consequently, maintaining flexibility in the guidelines is essential.

As a separate point, we are no longer in favour of the explicit rejection of global formulary apportionment methods as stated in paragraphs [3.58 to 3.74] of the 1995 Transfer Pricing Guidelines. Stated simply, we believe that businesses want certainty and administrative simplicity. They will accept any method of apportioning profits between tax jurisdictions provided it is easy to administer and they can budget for the consequences and accurately forecast the group's final profits and tax liabilities.

Elevating the status of the transactional profit methods to equal status with the traditional transaction methods is essentially a move towards formulary apportionment as profit split methods are, by their nature, dependent on the application of specific formulae.

We do not consider that the concept of formulary apportionment should be rejected as a matter of principle and we believe that it should be able to be applied in circumstances where such a method is agreeable to member countries. It may be, for example, that EU countries eventually agree the terms of a formulary apportionment method that may be used by specific industrial sectors. In such circumstances, we would like such a method to be available for use by groups with trading operations in the EU.

In addition to the certainty of taxation, the other big benefit to businesses of adopting a formulary apportionment methodology is that it reduces the burden on businesses of justifying its transfer prices and the need for detailed functional analysis. The cost of compliance is therefore very much lower.

We think a detailed discussion of the factors to be used as part of any formulary apportionment method is beyond the scope of this letter. However, methods applying, for example, the three factors, property, payroll and sales, as used for apportionment of profits for US state tax purposes, would form the basis for further discussion. These type of factors are already used for allocations in profit split methods (see our comments under the 5th bullet point of Issue 8 above). We strongly believe that the principle of considering such methods as acceptable is an important issue that should be given serious consideration by the OECD.

Issue 12 – Other issues

Please feel free to comment on any other issue you may wish to raise in relation to transactional profit methods.

Businesses don't really care about the rules but want only certainty and a simple way to use a method to reduce internal administration. Therefore, the option to use some form of formulary apportionment would be good. It could be introduced as an acceptable method and applied where the concerned jurisdictions agree to it.