Caroline Silberztein - CTP/TTP
Head of the Transfer Pricing Unit
OECD Centre for Tax Policy and Administration
2, rue André-Pascal 75775 Paris Cedex 16
France
Fax: 33 (0)1 44 30 63 13

Dear Ms. Silberztein:

Please find enclosed the response of members of Ernst & Young's Global Transfer Pricing Team to the OECD's Invitation to Comment on Transactional Profit Methods. The comments in this paper reflect those of the undersigned and do not necessarily reflect those of Ernst & Young LLP or any of its Ernst & Young International affiliates.

We welcome the opportunity to provide our experiences regarding this topical issue. We would also welcome the opportunity to provide further insight on these issues as you request. We have provided our individual contact information if you wish to contact any of us directly.

For organizational clarity, we have replicated the OECD's questions in *italic font*. Our responses follow each inquiry.

We authorize the OECD to publish our comments on the OECD internet site.

Sincerely,

Chris Faiferlick
Executive Director
Ernst & Young LLP
Washington, D.C
chris.faiferlick@ey.com
+1 202 327 8071

Robert Miall
Director
Ernst & Young LLP, UK
London
rmiall@uk.ey.com
+44 20 7951 1411

Paul Balkus
Partner
Ernst & Young Australia
+61 2 9248 4952 |
paul.balkus@au.ey.com

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

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 transactional methods are usually more reliable than transactional profit methods in part because transaction methods typically do not involve the transfer of valuable (and difficult to value) intangibles/services. However, the applicability of transactional based methods is very limited because the necessary data are rarely available and usually applies only to routine transfers of property or provision of services. The difficulty in applying transactional based methods would lead us to suggest that transactional profit methods (and particularly TNMM) should not be viewed as "methods of last resort" because the fact of the matter is they are often the only method available.

The phrase "method of last resort" has been interpreted by some tax administrations as requiring a taxpayer to prove that no other method can be used in any manner (e.g. by requiring the taxpayer to make numerous and often unreliable adjustments to remotely comparable transactions). In our opinion the phrase "method of last resort" has overly inhibited the use of an otherwise reasonably reliable transfer pricing method.

The reliability is a function of a relatively large number of databases about companies that operate in numerous industries and the ability to avoid issues arising from differences in accounting convention that affect two of the three transactional based methods.

We believe that the profit split method is becoming a more appropriate method for integrated cross-border operations. While there are instances where a globally integrated operation may be able to remunerate some of the value-added activities within the particular operation using conventional methods, there will be other operations where the residual profit of the activity should be allocated on some key or basis that attempts to measure the relative contributions brought forth by each entity (e.g., fully-burdened compensation).

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.

Ideally, the application of a transfer pricing method should not be dependent on the time of its application i.e., *ex ante* versus *ex post).* We believe the arm's length standard generally favors an *ex ante* approach and that at most the use of a different method during audit should only be considered a method to confirm the reasonableness of the primary method.

In a number of jurisdictions the resale minus method is used to set prices by targeting a net margin. However, it is difficult to view this as a truly transactional method. Its use reflects the difficult in determining arm's length gross margins in any other way.

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.

Our experience is that every industry encounters situations where an intercompany transaction is best served through the use of a transactional profit method, particularly the transactional net margin method (comparable profits method). We believe that numerous activities that face typical market risk within the industry it operates may be reliably modeled under the arm's length standard through the use of transactional profit method such as the transactional net margin method ("TNMM") or the comparable profits method ("CPM").

We believe a transactional profit method may be used reliably under business models where the type of activity/service is not subject to unusual risk bearing with respect to the industry in which the activity occurs. In such situations, the transactional profit method (such as TNMM) reasonably provides a return for the functions performed, the assets used to perform these functions, and for the risks borne to operate in the particular industry. Under such situations, we do not believe that a transactional profit method should be considered a transfer pricing method of last resort.

We believe that a priority of transfer pricing methods is no longer appropriate under the Guidelines. We believe that under a facts and circumstances test that each intercompany transaction should be modeled under a method that reasonably predicts what an arm's length party would expect to receive for a similar transaction recognizing that such modeling is inherently dependent on reliable and publicly available information. Consideration must be given to these two aspects of building an arm's length transfer pricing model and thus we believe ranking transactional profit methods as the least preferred method disregards the lack of reliable data to apply the heretofore favored transfer pricing methods.

With respect to profit split methods (including residual profit split methods), we are mindful that profit splits should be reserved for situations where more than one entity contributes valuable, albeit difficult to value, property or services. We think this threshold should be maintained to reduce the risk of the administration of the Guidelines becoming a form of global apportionment of system-wide profit (loss). We believe a profit split model may be also used in globally integrated operations where skilled professionals contribute valuable services to the overall result of the business objective, such as those that occur in global trading for financial services companies.

Thus we would not refer to the profit split method as a "method of last resort", but rather a unique method that should only be applied in certain circumstances.

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.

We believe the use of both profit methods arises because the market does not provide direct comparable evidence of a particular transaction or inherently aggregated set of transactions. The OECD recognizes that cross-border activity frequently arises because the market cannot otherwise provide an alternative for the related party activity that does in fact occur within the MNE. It should not then be surprising to the tax administrations that market data may not be readily available to test the arm's length nature of these intercompany transactions. We "admit" that the widespread use of transactional profit methods is due in part to the lack of comparable data to apply other transfer pricing methods. We are not surprised by this situation and recognize the lack of "razor-sharp" precision in such transactional profit methods; however, we believe that the purpose of the Guidelines is still being served under these transactional profit methods, that being, approximating what parties at arm's length would have charged each other under comparable circumstances. In particular, we believe the TNMM reasonably ring-fences what a party should earn for routine intercompany transactions that do not require the tested party to bear unusual risks.

We believe a distinction between the TNMM and profit split methods should be maintained as discussed above. Profit split methods should not be viewed as methods of last resort either, but rather, should be limited to special business model situations (two or more parties provide valuable (but difficult to value) intangibles/service and/or one or more parties bears substantial risk with respect to the business model results).

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

We would summarize our comments by encouraging the OECD to abandon ranking transfer pricing methods but instead provide guidance where one method may be more reliable than another keeping in mind the difficult constraint taxpayers have in finding reliable data to apply the various transfer pricing methods.

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.

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.

We believe that for significant and material intercompany transactions, the use of a second transfer pricing method to confirm what a taxpayer believes is the most reliable transfer pricing method is appropriate. We however do not believe taxpayers should be required to do this for all of its material transactions and such a decision should be left to it. In particular, the use of a secondary transfer pricing method should not be required when the taxpayer is not restructuring its business and residual profit is not being reallocated on account of the change in the taxpayer’s supply chain.

The TNMM may be used to test the reasonableness of a traditional method in certain circumstances. We think such a suggestion in and of it self supports why a transactional profit method such as TNMM should not be considered as a method of last resort because the question properly addresses the concern of whether a transactional method can always be used reliably particularly when reliable and publicly available information is lacking.

Great care should be taken in the use of the profit split method to “confirm” or “test” a traditional method. As stated above, we believe profit split methods should only be applied as a primary method in certain circumstances; either these conditions exist or they do not. Nevertheless, it is sometimes the case that the inevitable lack of precision in applying transactional methods, and, indeed, TNMM, results in controversy. It may then be appropriate to document the implied transactional profit split by way of corroboration without a requirement to undertake a full profit split analysis.

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.

We believe that a TNMM may be appropriate when the use of a traditional method leads to a low or negative profit with respect to the intercompany transaction. A tax administration may reasonably inquire whether such a low/negative return is in fact arm’s length over the long term. The result of the primary method may in fact be confirmed by a transactional profit method because of downturns in the business cycle or other short term phenomena.

By means of an example, the provision of information technology services may be referenced to comparable transactional data. Such an approach may initially appear to a tax administration as being less than arm's length. A comparison of what information technology companies earned after the bust of the dot.com bubble at the turn of the century would confirm that information technology companies were in fact earning negative margins. Such a return is plausible in the short term as the industry "sorted" itself out. Similarly an industry facing excess capacity may lead to similar results which support the "low" charge suggested by a traditional transactional method.

Issue 3 – Application of transactional profit methods and intangibles

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

When a valuable but hard to value intangible is transferred, it is helpful to corroborate the level of a royalty derived using another method by comparing the margins realized by similar entities without access to similar intangibles.

Otherwise, we do not think a TNMM will very often be useful to value a transfer of valuable intangible property as the TNMM will typically value an aggregated transaction such as a service that incorporates routine process intangibles. We think a profit split method may be useful to value the transfer of a valuable interest in intangible property.

A profit split method (including a residual profit split method) may be useful for valuing contributions of a valuable (but difficult to value) interest in intangible property to a related member. Such transfers are rarely found among unrelated parties and thus other evidence of how parties must allocate profit from such transfers must be used. Some methods would provide a residual return to the intangible provider and thus avoid the issue of how much the intangible cost to develop. This method is particularly appropriate where the intangible owner has proven some commercial value in the intangible and/or the intangible property is unique and protected by intellectual property law.

For situations where unproven intangible property is contributed, parties may devise a profit split method that allocates profit based on the capitalized costs of the contributed intangibles and services (assuming that risks are borne in proportion to these contributions).

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

Other than in the circumstances described in response to the previous question, we do not believe that a TNMM will ordinarily be useful in valuing non-routine intangibles. We believe that the TNMM would be limited to aggregated transactions that include the provision of functions combined with routine intangibles which are also owned by comparable companies.

A profit split may be useful in valuing an intangible interest transferred to a related party. The type of profit split method will vary depending on the stage of development of the intangible property interest as previously discussed.

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

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.

As a threshold matter, the contractual allocation of risk among the related parties should be respected absent a showing of a lack of business purpose and economic substance.

A TNMM would establish what a related party may be expected to earn if it bears the risks typically borne by the comparable companies. Such risks may include operational risk, credit risks, market risks, and so forth. A TNMM may be useful as setting a ceiling of a return that a related party may earn if certain risks are borne by other related parties. For example, if the related party does not bear credit risk because such risks are managed in a centralized entity, transactional data may be used to value the transfer of such credit risks and such return could be reasonably excluded from the return of the set of otherwise comparable companies.

There are certain extreme cases in which the functions and risks of a controlled entity are so limited that the transaction can be most helpfully seen as the provision of the service, rather than, for example, the supply of goods. In such cases a transactional profit method can be used to determine the level of the entity's reward.

An example would be a buy/sell entity which essentially fulfills a simple order taking function and has no responsibility for selling products or for logistics and thus bears none of the corresponding risks.

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

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)

With respect to sub-issue 1, we think the request for information should be limited to the type of information is required to implement the transfer pricing method chosen by the taxpayer. We think that if the tax administration desires to test a confirming method, a taxpayer should not be ordinarily burdened with providing such information to the tax administration. It may very well be such a confirming method was not chosen by the taxpayer because it could not reasonably obtain such information itself. Managerial type of information should be limited to confirmation about which entity bears significant risks. Managerial information that seeks to extract certain type of behavior to enhance the synergies of the MNE may be counter-productive in applying the arm's length standard and should not necessarily be requested by a tax administration.

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.

With respect to sub-issue 2, we believe that if a foreign party is the tested party, a tax administration should be able to obtain relevant information to audit the proffered transfer pricing method. The information requested should be no more than what a tax administration would expect if the related party in its jurisdiction was the tested party in a similar situation.

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).

With respect to sub-issue 3, the information requested should be limited to what would be normally expected to support the transfer pricing method proffered by the taxpayer. The request for information should be no more onerous than what would be requested if the tested party operated in the tax administration's jurisdiction under a similar situation.

With respect to a profit split application, detailed information may not be needed if a residual profit split approach is employed. Detailed information may be required in situations where a capitalized cost approach is used to apportion the value provided by the various related parties.

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

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?

Tax profits do not seem to us to be the right starting point for a profit split analysis as it is very unlikely that unrelated parties or potential participants in a joint venture would set prices or share profits on the basis of tax accounting.

Beyond this it is difficult to generalize. Facts and circumstances will dictate which of (at least) the following options is appropriate:

- A sharing of revenues leaving both parties responsible for controlling their costs;

- A gross profit measure leaving them responsible for managing their overheads;

- Operating profit before or after corporate costs.

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

The difference in what profit level should be used depends in part on whether parties at arm's length would expect each party to bear and manage their own costs.

For integrated operations where one entity undertakes certain activities and the other undertakes other complimentary (whether in function, time, or location) activities, a profit split after direct and indirect productions costs are accounted for may be most appropriate. However, corporate overheads might be left for the account of the parties.

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?

The above suggests that direct and indirect production (or equivalent) costs should be charged. However, indirect corporate costs which the parties might have difficulty in agreeing on might be left out of account.

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?

Facts and circumstances should be the basis to determine operating income. Since the transfer pricing model attempts to approximate what parties at arm's length would have done, reference to what these parties may consider to be relevant costs would be appropriate. Consistency in application within the MNE is important and more emphasis should be placed on the economic costs to generate the income and less emphasis on accounting differences amongst various jurisdictions.

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?

Gross profit allocation should be more concerned with risk allocation than with accounting for functional activity expenses. For example, there may be situations where risk bearing is not wholly dependent on the amount of functional activity or parties would expect each entity to manage its own costs.

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

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

A residual profit split will often be more reliable than a contribution analysis because transactional based or TNMM transfer pricing models may be used in allocating the profit from the integrated activities to activities that are of a routine nature or use no more than routine assets.

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 most appropriate in financial services situations where most of the value added activities are in the form of compensation to highly skilled professionals. Another situation is where a new or relatively new business operation is being undertaken and the various costs associated with starting the business can be used to derive capitalized cost contributions.

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

We have experience of cases in which the contributions of the parties are diverse and cost or other quantitative allocation keys are unlikely to provide a reliable guide to how residual profits or prices would be determined at arm's length. In these cases we have used business modeling techniques and interviews with management to analyse the contributions of each party to value creation. Although subjective, the analysis is based on developing a consensus among senior commercials management on the determinants of the profitability of the business backed up by published data such as analysts' reports.

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

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

Data regarding profit splits is available in differing contexts. Franchise agreements provide data for what a licensor may expect to earn as a residual profit taker. Joint ventures provide evidence for unique situations where parties at arm's length focus on a particular business operation or geographic market. Numerous examples include:

- Pharmaceutical collaborations
- Recent trends among independent music record labels to adopt a residual profit split of 50:50 with music artists after routine production expenses are recovered
- Oil production arrangements

Splits of profits based on how to invest capital are prevalent throughout the financial services sector (e.g., hedge fund models).

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

Profit split data from the market place assists in reducing the controversy associated with how much risk takers may earn or how parties allocate the residual profit from exploitation of unique intangible property.

However, tax administrations should note from these actual arrangements and the literature on this topic, that profit split arrangement are inherently imprecise. In fact, one of the reasons that 50:50 profit splits are so prevalent is the lack of precision in determining what each party's contribution may be and the need for some simplicity to structure the arrangement.

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

Profit split analysis should be based on reliable external data to the maximum extent possible. Once that limit is reached an apportionment mechanism must be found. In some cases, as indicated above, capitalized cost may provide an answer. In others, as already suggested, structured interviews with senior commercial management may provide a basis for determining a result which is reliable because of its foundation in deep commercial insight and its consistency with the views expressed by managers and commentators in other contexts, for example statements to financial markets.

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

The contribution can be measured in numerous ways. In some instances the contribution of capital (and bearing of failure risk) or an intangible may be sufficient to give it a substantial share of profits with the other party providing all the activities needed to execute the strategy.

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

For contribution profit splits, compensation is frequently used in situations where services are the primary factor in generating the integrated profit (loss). For situations where commercially unproven intangibles are contributed, a capitalized cost approach in conjunction with a compensation factor may be appropriate.

For residual profit split analysis, broad-based profit split economic data may be appropriate. In addition a residual profit split may be performed in conjunction with a TNMM or transactional based approach to determine what residual income should be allocated among the non-routine factors of production.

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).

We cannot conceive a situation where a different allocation key should be used depending on whether there is a profit or loss. We think the integrity of a profit split transfer pricing method requires that the same allocation key be used whether profits or losses arise. If for some reason one entity cannot bear short term losses, other intercompany transfer pricing mechanisms exist to resolve such a situation (e.g., without resort to a change in allocation keys).

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

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)?

A lower comparability standard should apply for the TNMM because an aggregated set of functions performed, assets used, and risks borne are generally being measured in the comparable set to similar but not exact functions performed, assets used, and risks borne by the tested party. Inherently, different levels of intensity will exist and reliable adjustments may not be able to be made in many circumstances.

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)?

We believe the TNMM can be reasonably applied at a company-wide aggregated data level. We believe the difficulty in obtaining segmented comparable data outweighs any marginal improvement in the potential arm's length results.

We believe more broadly based comparable data may be used reliably to measure an aggregated set of activities of the tested party. We would not necessarily describe this as a lowering of the standard for comparing comparable transactions.

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

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?

A net margin is typically defined as:[1]

[1] "Net margin" definition provided by Investorsworld.com available at http://www.investorwords.com/3253/net_margin.html.

> Net profit divided by net revenues, often expressed as a percentage. This number is an indication of how effective a company is at cost control. The higher the net margin is, the more effective the company is at converting revenue into actual profit. The net margin is a good way of comparing companies in the same industry, since such companies are generally subject to similar business conditions. However, the net margins are also a good way to compare companies in different industries in order to gauge which industries are relatively more profitable.

For some industries, EBITDA or some equivalent profit definition is used. For non-financial services situations, the amount of interest should be excluded from determining the net margin as the capital structure chosen should not effect the amount of income earned from selling products/services to unrelated parties.

We think the TNMM is affected if the tested party does not perform the same broad based activities as the comparables. Adjustments in such circumstances may be required.

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

We think net margin should be compared to sales or costs depending on the facts and circumstances. We think the use of assets will be limited because of issues regarding whether accounting treatment of assets is done on a fair market value basis.

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?

Except for distribution activities, net margin to costs would generally be the more reliable comparison.

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

Segmented cost data is usually unavailable for most MNE operations. Similarly segmented cost data for companies that report financial results is unavailable.

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

It is generally not possible to compare either the precise allocation of costs between cost of sales and operating expenses or the allocation of functions between the parties as between controlled and uncontrolled transactions. In particular, it must be recognized that many multinationals centralize functions in pursuit of consistency and efficiency.

These factors make it virtually impossible to apply the resale price method unless the taxpayer has unrelated transactions which are comparable.

Moreover, in gross margin data are not always available in databases.

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

The answer depends on what is meant by market value. The implicit value placed on assets by financial markets is unlikely to be a reliable basis for valuation because of problems of circularity. Financial markets establish asset values on the basis of expected returns and a discount rate. The purpose of the benchmarking is to evaluate the level of the rate of return and this will be obscured if the returns are reflected in the asset value.

However, if assets can be measured on a replacement cost basis this is likely to be preferable to valuation on an historic cost basis because replacement cost provides a more reliable measure of the capital needed to participate in the line of business. Nevertheless, problems remain related to the life of assets. Two companies otherwise very similar will show very different rates of return according to the age of their assets if net book value is used as the basis for valuation.

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

The Berry ratio is a useful measure when the entity only controls a small proportion of its total costs.

Issue 11 – Other methods

Commentators are invited to indicate what type of other methods not described in the Guidelines might be used in practice and for what reasons.

There are numerous fair market valuation approaches used in non-tax contexts that may be useful under the appropriate facts and circumstances. The following may be appropriate:

- Replacement cost new approach – this approach values the transferred property and what it would have cost to reproduce the property under current market conditions. This approach is particularly relevant for property that is subject to rapid obsolescence such as internal use software.
- Income approach – the value of a transferred asset or business opportunity may be accurately measured through a form of the discounted cash flow model.
- Real option approach – a transfer or an intangible may be accomplished through the use of a real option model that allows the

parties to bear risk of research and development in a variety of manners.

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 agree that global formulary apportionment is inconsistent with the arm's length standard and thus should be rejected.

We believe that the practical difference between the U.S. based CPM and the OECD TNMM revolves on whether there is a range of arm's length results and if so what is an acceptable point for a taxpayer to choose. In the context of a self-assessment system, the OECD should encourage that the taxpayer's choice of a point among potentially arm's length results should be respected by the tax administrations. Needless tax controversy arises when tax administration auditors substitute their judgment for the business judgment of the taxpayer.

Issue 12 – Other issues

The OECD should make clear that the profit allocations related to Article 7 do not apply to Article 9 situations.