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Corporate Finance Taxes

OECD Centre for Tax Policy and Administration
Mrs. Caroline Silberztein
Head of the Transfer Pricing Unit
2, Rue André-Pascal

75775 Paris Cedex 16

France

Name	Bremer
Department	CF Taxes
Phone	+49-89-636-30242
Fax	+49-89-636-33829
E-Mail	sven.bremer@siemens.com
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OECD – Comments on the application of transactional profit methods

Dear Mrs. Silberztein,

We are delighted to have this opportunity to comment on a number of issues in relation to transactional profit methods.

Meanwhile, if we can be of any immediate assistance please feel free to contact us.

Very truly yours,

Siemens AG

i.V. Werner Stuffer i.V. Dr. Sven Bremer

Enclosure

Corporate Finance

Taxes

Head:
Fritz Esterer

Address:
Siemens AG
D-80312 München

Wittelsbacherplatz 2
D-80333 München

Telefon (0 89) 6 36 - 00

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

Theoretically, the traditional transaction methods are more accurate and reasonable than other methods. Its current label as a method of last resort means that tax authorities tend to put low reliance on transactional profit methods. The disadvantages of transactional profit methods are inter alia that it has been seen to be manipulated and become an economic and mathematical tool such that a company's results can always be made to 'fit within the range'.

However, practice shows that there are many instances where a traditional transaction method is not available or reasonable for determining transfer pricing. Therefore, the status of transactional profit methods as methods of last resort is certainly not advisable because of the following reasons:

- In most transfer pricing compliance situations multinational taxpayers are forced to resort to the transactional profit methods due to data availability constraints that hinder the application of any of the traditional transactional methods. In most cases, situations where data is not available or not of sufficient quality is the norm rather than the exception and therefore considering these situations exceptional does not reflect practical reality.
- The wide-spread application in OECD countries with their slightly different regulations has indicated that the transactional profit methods are equally reliable in assessing an arm's length result as the traditional transaction methods. Quite often transactional profit methods are used as supporting method to a traditional transaction method or vice versa because of different reasons. Practice shows when a support method was used, one was able to reach the same conclusion. The practical assertion of the reliability of the transactional profit methods therefore supports the view of changing their treatment as inferior or last resort methods.
- The lack of data (predominantly for comparables) and in quite a few cases for the tested party (appropriate data on a transaction basis) and accounting inconsistencies are the leading reasons for the use of transactional profit methods.
- The widespread use of the transactional profit methods both by companies and tax authorities is another practical and statistical indication that these methods should not and are not being used as last resort methods.

The difference between the purpose of the exercise – transfer pricing audit examination, planning or compliance is a very important one. For instance, although one method could be used to set transfer prices, another could be used to test whether such prices are at arm's length. Nonetheless, given the high degree of comparability that is required for the application of the traditional transactional methods, one is tempted to conclude that from a transfer pricing planning perspective, it may be better to rely on a hierarchy of methods beginning with the CUP in order to set transfer prices. In many instances, if a multinational is transacting with both related and unrelated parties, an internal CUP may be available. In addition, using the traditional transactional methods to set transfer prices does also lend itself to some degree of consistency within a global multinational. For instance, it is much easier to plan and implement a universal CUP, cost plus or a resale minus transfer pricing policy for similar types of entities operating in diverse markets. For planning purposes, this may be much better than using the transactional profit methods since they depend crucially on comparisons to third party comparables in local markets and consequently the targeted margins may be drastically affected by local economic and market conditions.

That said many multinationals target specific operating margins in their operations and transactional profit analyses confer the advantage of examining whether such margins are at arm's length. In this scenario, the use of a transactional profit method such as the TNMM might help ensure that the targeted operating margins are reasonable and can be defended from a transfer pricing perspective. In general, whether for compliance, audit or planning purposes, the choice of the method should be based on whether or not the method yields the best possible result and aids in the verification of whether a transaction is at arm's length reliably. The choice of a method should not be dependent on the purpose of the exercise such as setting the price for future transactions or testing the outcome at year end or during an audit; the choice should be focused on the appropriateness of a method to assess an arm's length result.

In our view the transactional profit methods are not particularly appropriate for certain industries; however, they are quite useful in cases when intangibles are involved. In cases when one needs to define above routine profitability due to intangibles or to find a way to split the income between two related parties that contributed together to the development of an intangible, one would normally use the TNMM or a profit split method.

Overall, while the hierarchy of transfer pricing methods can still be retained given the higher degree of comparability required to apply the traditional transactional methods, it would certainly be prudent to not relegate transactional profit methods to the status of "last resort" methods for both compliance and planning purposes. In our view the distinction of methods of last resort and "primary" methods is artificial and does not reflect the fact that transfer pricing does not take place in a perfect world. The choice of a method should not be driven by data available nor by predefined "quality" of methods. Availability and reliability of data both internally and externally are the driving factors behind the choice of a method. The best argument in this direction comes from the CUP method – theoretically, this should be the most reliable method. Practically, however, if all requirements of the method are to be met, only in exceptional cases a company will be able to justify a CUP for its transfer pricing purposes.

Issue 2 – Use of 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

The use of more than one transfer pricing method from a practical perspective may be justified more from a risk management perspective rather than for any economic reason especially in circumstances when the results of the application of a traditional transactional method is unreliable. Given the onus is on the taxpayer to prove that their transfer prices are at arm's length and given the data availability constraints, taxpayers often use a transactional profit method such as the TNMM to corroborate the results obtained by the application of a traditional transactional method such as the CUP, Cost Plus or Resale Price. In fact, in most instances, such corroboration is used as a sanity check by taxpayers to ensure that their transactions are at arm's length.

In practice, a multinational taxpayer may use the resale price method using internal comparable transactions to test the resale margins provided to a distributor and then corroborate it with the application of the TNMM to test the net margins. This may be prudent since such corroboration may help justify not only the resale margin but also the net margin earned by an entity. In the same vein, a taxpayer may also corroborate an imperfect CUP analysis with a TNMM. The profit split method can also be used to corroborate results when valuable intangibles are involved as part of the intercompany transactions and may help in demarcating the routine vs. the non-routine returns earned by an entity.

Issue 3 – Application of transactional profit methods and intangibles

When intangibles are embedded as part of an intercompany transaction and especially if such intangibles are unique, the application of any of the traditional transactional methods is very difficult. This is primarily due to the fact that finding similar internal or external comparable transactions, using the same or similar type of intangibles, is practically next to impossible.

Given these constraints, the reasons to consider transactional profit methods are particularly compelling. From a practical standpoint, the TNMM, which is a one-sided test allows one to determine the returns that can be attributed to routine functions. Therefore, the TNMM can be used to determine routine returns of the simpler entity involved in the intercompany transaction and indirectly help determine the additional non-routine returns that can be attributed to the intangibles. Practically, the TNMM is therefore used when one needs to determine a royalty that needs to be paid to a related entity that developed an intangible entirely on its own which plans to license the intangible to an entity that did not participate in the development of the intangible. The TNMM would be used when an appropriate CUT does not exist and neither a resort to a profit method to determine an arm’s length royalty rate. Under this scenario one will apply the TNMM to determine the routine profitability of the licensee and assign the above routine profitability (determined on the basis of real numbers or forecasts) to the license payments.

However, the TNMM method is of limited use when intangibles are shared between the related parties. In such a scenario, a profit split method seems the best method especially since as a two-sided test it can allow one to determine both routine and non-routine returns and further the split of the non-routine returns between the entities that contribute to the development of the intangibles. For example, two related entities have contributed to the development of intangibles and the income generated by this intangible needs to be allocated, at a first stage, the TNMM is used to assign routine profitability to the two entities and then the above-routine profitability is split on the basis of their cost contribution to the development of the intangible.

Overall, both profit split method and TNMM are most suitable for an estimation of the contribution of an intangible to the profitability of an operation as they allow differentiating between routine profitability and the true contribution of an intangible to the bottom line. In certain cases a transactional profit method may provide better results than a traditional transaction method. For example, initially one may believe that a given intangible is very profitable, and assign an arm’s length royalty rate based on an available CUT transaction; but when this royalty is later in time reviewed one may not able to justify it on the basis of the income generated from the application of the intangible in question.

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

One of key elements of a transfer pricing analysis that involves the application of a transactional profit method is the consideration of functions performed as well as the risks assumed by the related parties. A key objective of this functional and risk analysis is the characterization of entity types, i.e. whether the related parties act in the capacity of entrepreneurs, distributors, manufacturers or service providers. However, the usefulness of the risk analysis does not stop there, it also allows one to fine-tune the entity characterization to account for different types of structures within an entity category, i.e. whether a manufacturer is a full-fledged manufacturer or a limited risk/contract manufacturer as well as hybrid entity types, i.e. a distributor that performs value-added assembly or manufacturing functions in relation to some of the products it distributes. This type of fine-tuned analysis is crucial to determine whether the comparables being considered are truly comparables. For instance, comparing a value-added distributor's margins with routine third party comparables will not be a true one-to-one comparison and additional adjustments may have to be performed to improve comparability. Indeed, a proper consideration of risk may help identify risks that are not routine for which an additional return above normal margins may be due to the entity that is bearing such risks. On the other hand, it may also help point out certain risks that are not being assumed which are normally assumed in which the margins due may be much lower.

On a practical level, one could determine the routine returns attributable to an entity through the application of the TNMM and then perform specific adjustments to the arm's length range derived from this application to account for the additional risks that are assumed or normal risks that have not been assumed. In essence, through such adjustments the arm's length range of the comparable distributors might be adjusted upwards or downwards to account for the additional risk. This type of analysis, however, is only possible if one properly identifies the risks assumed by the related parties in relation to third party comparable companies.

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

Although the OECD Guidelines are accepted as the pre-eminent guidance on transfer pricing within the OECD, it is patently unclear why the OECD is contemplating including access to information provisions within the context of the Guidelines. Indeed, given that the original purpose of these Guidelines is to provide guidance to taxpayers and tax administrations alike on transfer pricing documentation, it is rather counter-intuitive to include access to information provisions that not only aid tax administrations to the detriment of taxpayers in terms of the increased compliance burden but also need the force of law to be effective.

In addition, each transfer pricing case has its own unique compliance requirements and many taxpayers already undertake extensive documentation processes to justify their transfer prices through the preparation of contemporaneous documentation that often includes extensive information on the related parties, including foreign-based related parties. In addition, many jurisdictions already have legislation in place to empower auditors to request information, including foreign-based information, to verify the facts presented in a taxpayer's compliance documentation. Given this situation, there is very little need for the OECD to address this particular issue in the transfer pricing documentation requirements and is best left to the legislative process in the individual tax jurisdictions.

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

Determining the profit to be split is one of the most important issues that need to be resolved when applying the profit split method. Although one could use gross profits as the profit to be split, taxpayers generally shy away from using gross profits, chiefly due to the lack of consistency between different countries, within and outside the OECD. This fundamental problem arises due to the fact that the profit split method is a two-sided test, i.e. both parties involved in the transaction need to be evaluated, and as such one needs to be consistent in the analysis of both related parties, notwithstanding the country where these parties are situated. The lack of consistent financial accounting standards implies that third party comparables situated in different countries may calculate their gross profits differently and therefore any comparability analysis that is made at the gross profit level may be inherently unreliable. One key issue in this context is how depreciation is treated and included in different jurisdictions. Another is the accounts included as costs of goods sold in certain countries. A third issue is that the formats of the audited and publicly available financials themselves are inconsistent between different countries.

On the other hand, operating profit measures are generally not as dramatically skewed by inconsistent account classifications as long as one is able to fairly consistent define what is included in the calculation of the operating profit. Where operating profits are used, the identification of the appropriate operating expenses and cost allocation are normally done on the basis of records for the costs associated with the development of a specific intangible that were recorded or forecasted by the related entities involved. If such records or budgets do not exist, the identification and allocation of costs becomes a questionable guesswork.

In this context further guidance would be welcomed in respect to how costs should be allocated to a particular transaction, perhaps by using an economically justifiable cost driver. In our view such guidance should be included in the OECD Guidelines as well so that multinational taxpayers can consistently apply the profit split method.

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

In the context of the application of transfer pricing methods, once the total profit to be split is identified, the profit can be split using either a contribution or a residual analysis. A contribution analysis is best applied when one can find a direct correlation between the relative contribution of the parties to the intangible value-creation process and it is relatively simple to demarcate the relative contributions. For instance, if the transaction is between two related parties, one of whom conducts, say, product related R&D for the development of product components and other focuses on assembly of the product using proprietary technology, then the total profit may be split based on their individual relative contributions. However, when the demarcation of the relative contributions is not simple, when the same/similar functions are being performed by both entities and especially when relative contributions do not accurately reflect the value-add, then contribution analysis may not be the best approach.

In such cases, a residual analysis might be better simply because the split is achieved by undertaking two distinct steps, i.e. the determination and split of the routine profits and the determination and split of the non-routine profits. Usually, routine profits can be easily identified by reference to third party comparables' margins. Once the routine profits on both sides of the transaction have been identified, it is only the residual profit, i.e. the profit associated with the shared intangibles that remains to be split. This exercise is considerably easier and a lot less subjective than splitting the total profit between two entities who share intangibles.

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

Using external data to support the profit split is by far the most objective way to apply the profit split method. Therefore, there is no doubt that using external data to support the division of profit is both relevant and objective. Whether using external data is reliable is of course an entirely different question. In fact, reliability of a profit split analysis using external data depends on both the quality of the data that is available as well as the economic rationale behinds its use. Therefore, although one might argue that using external data is an objective way of applying the profit split method, it is not advisable to conclude that objectivity automatically implies reliability. In the absence of reliable external data, therefore, it may be better to perform the profit split analysis using an economically justifiable allocation key.

Economically justifiable allocation keys may include, among others, assets employed, costs incurred, employees involved, time spent etc. However, in every case, the key used should accurately capture the extent of the relative contribution of the parties and have strong correlation to the value-drivers that influence overall profitability. For instance, if the intangible value creation is driven by the time spent by a certain group of employees in both entities and there is a strong correlation between the time spent and the intangible value, then it makes sense to use the time spent by this particular group of employees rather than any other key. In addition, if one cannot correlate any one key strongly with the intangible value creation, then multiple/hybrid keys can also be used.

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

Traditional transactional methods rely on transactional/product level comparisons and examine individual product/transactional margins while the TNMM relies more on functional/risk comparisons and examine aggregate profit margins with less emphasis on product/transactional level analysis. In essence, when applying the TNMM, one is more concerned about making comparisons between the related parties and third party companies that operate in a similar capacity, i.e. as distributors, manufacturers or service providers. Consequently, the functions and risks performed by the entities is more important rather than product or transactional similarity and therefore, one could argue that a lower comparability standard is acceptable for the application of the TNMM vis-à-vis the traditional transactional methods.

When applying the TNMM, taxpayers are forced to use aggregate level data primarily because third party comparables' margins are reported on a aggregate basis rather than on a transaction-by-transaction basis. Indeed, even if were to attempt to calculate transactional net margins, it may not be reliable and pose numerous difficulties during the course of transfer pricing audit. Therefore, this lower standard with regard to the use of third party comparables data is forced upon the taxpayers by data availability constraints primarily.

Certain taxpayers do track profitability on a transactional basis and do attempt to use these margins when conducting their transfer pricing analyses. Nonetheless, the level of detail that is available in a taxpayer's financial reporting is quite often dictated by the resources available and is neither universal nor consistent across taxpayers. Even so, even the most sophisticated taxpayers will have to contend with publicly available third party data that is often only reported on an aggregate level.

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

As mentioned, net margin is defined as the ratio of operating profit to a base such as Sales, Costs or Assets. The key here is of course defining what the operating profit should be for transfer pricing purposes since it generally differs from the operating profit calculated for financial accounting purposes in that it excludes interest payments and receipts, income taxes, one-time expenses (such as restructuring and unanticipated severance and legal charges), non-operational expenses, extraordinary and/or unusual items. In addition, foreign exchange gains and losses that are not directly related to operations such as hedging gains and losses are also excluded. Although the response to the above question is pretty consistent no matter which entity is being examined, there are instances when the net margin may include or exclude certain expenses depending on whether such expenses can be considered to be part of a company's day-to-day operations.

The net margin should ideally be calculated using a base that is not affected by the controlled transaction, i.e. the intercompany transaction. Alternatively, one may also choose a base that is best reflective of how the entity generates operating profit. Therefore, applying this logic one is able to arrive at the following conclusions:

- For a distributor, the Costs of Goods Sold are controlled, therefore, the base to be used is Sales

- For a service provider or limited risk manufacturer, Sales are controlled, therefore, the base to be used is Costs (of service provision)

- For a full-fledged manufacturer, given that such entities employ significant Assets in their operations which are very important to generate operating profit, one can use Assets as the base. Assets also tend to be a reliable base for distributors since they are less susceptible to wide fluctuations between one year to the next.

When the indicator is net margin to costs, all costs that are related to the activity that is being performed should be included. Given that a net margin to costs is generally used to test service providers, this implies all the costs of service provision. Although one could use the gross cost plus indicator, the use of this indicator suffers from the lack of consistency in accounting for expenses above and below the gross profit line. Therefore, most taxpayers prefer to use the net margin to costs since it is not afflicted by this particular problem. The best way to ensure that the appropriate costs are included is by examining the cost accounts and investigating whether or not the costs included bear a direct correlation to the activity that is being performed to generate the operating profit for the entity whose net margins are being tested.

The net margin to sales ratio is generally used to examine distributors and given that most distributors account for their costs of goods sold and operating expenses in a fairly consistent manner, it is comparatively easier to use the gross resale minus indicator to test distributors. Nonetheless, in instances where distributors perform additional value-added functions in addition to routine distribution, the account classifications above and below the gross profit line become a lot more inconsistent across companies. In such situations, it may be better to use the net margin to sales indicator instead of the gross resale minus indicator.

When using the net margin to assets as an indicator, there are a few issues to be considered. One of the most important is the definition of assets, i.e. whether they refer to current assets, fixed assets or both, whether they include or exclude cash and/or intangibles etc. The other issue is the consistency in the age of the assets that are being used for comparison purposes. A third is how such assets are valued, i.e. whether book values are used or market values. From a practical standpoint, it is preferable to use book values of assets since they are more easily verifiable than market values. Nonetheless, no matter which value is used, there should be consistency between the taxpayer's assets and the third party comparables' assets, i.e. one should not use market values for the taxpayer's assets and compare them with the book values of the comparables' assets.

Issue 11: Other methods

From a practical point of view, the use of other types of methods is not always advisable since it naturally lends itself to controversy especially since there is an enormous risk that the economic rationale used by a taxpayer to justify a certain method is not accepted by the tax administration since it is not explicitly sanctioned by the OECD Guidelines. Therefore, practice shows that transfer pricing practitioners steer generally away from using other methods as they are fearful of being accused under a transfer pricing audit of engineering a suitable method to justify a specific result that would normally not be justified under one of the standard methods. The widespread perception is that the mere application of other methods in a documentation report may trigger a transfer pricing audit. Nonetheless, it is also important to point out that the Comparable Profits Methods is widely used in the United States and recognized as a valid transfer pricing method by the Internal Revenue Service.

Still, the lack of proper guidance in the OECD Guidelines on how exactly these other methods should be applied does leave the door open to debate and argumentation if and when a particular taxpayer attempts to use these so-called "other methods" to justify their transfer prices. Therefore, it would serve the entire transfer pricing community well if the OECD Guidelines clearly stipulated the fundamental economic criteria by which these other methods will be judged.

Regarding methods that are considered non-arm’s length, i.e. global formulary apportionment, there has been much inconclusive debate on whether this can be used as an acceptable alternative transfer pricing method. Nonetheless, if the arm’s length standard is the gold standard of transfer pricing then any acceptance of such non-arm’s length methods may run counter to the fundamental objective of the OECD Guidelines, i.e. to provide guidance on how to document arm’s length transactions between related parties. Still, it may be instructive to evaluate whether the arm’s length principle is a practically achievable standard in a world of multinationals who achieve efficiencies primarily by relying on their international networks composed of non-arm’s length related entities.