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15 September 2006

Our ref: RH/IM

Dear Caroline

Deloitte member firms welcome the work that OECD is performing in this crucial area and appreciate the opportunity to provide their input.

The comments, attached, are offered within the body of the OECD paper, which we hope will be helpful, and reflect the input of Deloitte Transfer Pricing specialists from Deloitte member firms on a global basis.

They proceed on the understanding that it can be assumed that a reasoned analysis of both transactions and entities involved in those transactions will have been undertaken, complete with requisite functional and risk analyses, in order to provide appropriate comparisons necessary to apply the arm's length principle, whether one is concerned with adoption of a Traditional Transaction Method or Transactional Profit Method. For that reason, this point is not repeated within the body of our point by point comments.

With best wishes for your continuing work in this area.

Yours sincerely

Ron Haigh  
For Deloitte & Touche LLP

Enc
INVITATION TO COMMENT ON TRANSACTIONAL PROFIT METHODS
LIST OF ISSUES FOR CONSIDERATION

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.

*It is no longer accurate to describe Transactional Profit Methods as methods of last resort – because it is no longer true to say that cases in which “the complexities of real life business put practical difficulties in the way of the application of the traditional transaction methods” are exceptional (Transfer Pricing Guidelines (“TPG”) Para 3.2). Complexities of life in the transfer pricing world have increased since 1995 and it is much less true (if it is any longer true at all) to say that “in the majority of cases, it is possible to apply traditional transaction methods” (TPG Para 3.49). This is so whether one is considering potential application of the profit split method or the transactional net margin method.

We have seen all of the methods, including “Other Methods” appropriately and successfully applied in recent years. Almost without exception, the actual application of a method requires some judgement to be made in regards to reliability. Often it is the Transactional Profit Methods that prove to be the most robust and to require the least adjustment, whereas a CUP or other Traditional Transaction Method may require such extensive adjustment as to render it entirely unreliable.

Care should nevertheless be exercised to ensure that Transactional Profit Methods are applied to the appropriate sub-set or aggregation of transactions and not used in a blanket fashion which may over-emphasise or overlook significant risks or functions.

We have seen situations where a tax authority has attempted to use a Transactional Profit Method to attack the application of a CUP, which suggests that some tax authorities themselves regard the hierarchy as less relevant than it was on initial drafting of the TPG.

- 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?
We take the foregoing view irrespective of whether the transfer pricing method has been used to set the arm’s length price or is being applied to test the outcome of already completed transactions. More generally we believe that existing Para 1.68 of the TPG should be maintained.

We do acknowledge that the method selected and used as the most appropriate for setting pricing may not be the same as the one considered most appropriate for testing satisfaction with the arm’s length principle due to changes in data availability or in commercial circumstances related to the transaction under review. A taxpayer should be able to justify such a change in approach and should be allowed to do so.

One concern experienced in applying different methods is that tax authorities are often reluctant to accept that there are “bad deals” between third parties and that these are not always immediately renegotiated. Any application of a different method should not overlook legal and commercial realities.

- 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 appropriate application of Transactional Profit Methods tends to be driven not so much by the nature of the particular industry involved but rather by the nature of the activities in question, manner in which modern business models address those activities, the degree of integration of the business and the role of valuable intellectual property in connection with that business. This does, however, have a natural impact on some types of business more than others because they are particularly suited for conduct on a highly integrated basis – such as businesses in the financial services sector. The place of Transactional Profit Methods in the hierarchy of methods should have regard to such factors as well as to the consequential degree of reliability of information on comparables that can be established to apply both the Traditional Transaction Methods and the Transactional Profit Methods.

- 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.

As reflected above, Transactional Profit Methods are increasingly relevant and may be appropriate as solutions to cases for which reliable application of Traditional Transaction Methods is frustrated by, for example, lack of valid data in respect of comparables.
It is vital to allow taxpayers the flexibility to select the most appropriate method, regardless of hierarchy, provided the method can be supported by clearly defined and reliable data.

- 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.

- 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.

The emphasis in existing TPG Para 1.69 on the lack of a requirement to apply more than one method and recognition that to do so would create a significant burden on taxpayers should be maintained. Of course, if taxpayers themselves wish to ensure that their approach to establishing prices remains arm’s length and conduct a check adopting a secondary method, this may provide relevant evidence. But this should be optional and not a requirement.

Similarly, application of more than one method to establish arm’s length pricing whilst it may be recognised as potentially helpful to taxpayers should not be expected of them. The most obvious instance where such an approach might be adopted is in cases involving valuable assets where a residual profit split is applied following application of a Traditional Transaction Methods or Transactional Net Margin Method to provide each party with a basic return for its general functions/risks. (see additional comments on contribution-based profit split in Question 3)
The application of a second method can be useful in narrowing any range of prices provided by the most appropriate method. For instance a CUP related to the factoring of receivables may help place a comparable distributor at the higher or lower end of a range of results presented by a Transactional Net Margin Method, even if it can not be used as the primary means to establish whether or not the pricing for resale of goods is arm’s length.

Care should be taken with the application of any additional methods since, following application of the most appropriate method, such an additional method can be expected to be less reliable than the primary method. Where differences are found, this may be more related to the failure of the second method accurately to reflect all of the functions or risks, as opposed to the pricing being non-arm’s length. It does raise the question: Why use a “worse” method to test the most reliable one?

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,

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

In addressing this question we observe that at present Chapters I-III of the TPG generally deal only with “intangibles” – which are also variously labelled “valuable”, “unique” and “marketing”.

A difficulty associated with this is the fact that there are various types of intangibles, possessing different qualities and different status in law as a result of which different transfer pricing considerations will, as reflected below, apply to them. We believe it would be useful if OECD recognise this in developing these Chapters of the TPG and more clearly distinguished between different types of intangibles.

So, for instance, situations involving intangibles where a profit split may be particularly or exclusively applicable are those in which a valuable and unique intangible is used – for instance intellectual property such as a brand or copyright. In such cases, the importance of the intangible in respect of the transaction in question may preclude application of any other Traditional Transaction Methods or the Traditional Net Margin Method.

But it would be wrong to draw from this the conclusion that this is the only reasonable approach where one or both parties to a transaction possess “intangibles” employed in the transaction. Where these are more routine or low level intangibles it may be possible to locate comparables permitting use of the Traditional Net Margin Method or even Traditional Transaction Methods. As indicated in relation to Issue 2, it may also be appropriate to apply a residual profit split approach in conjunction with another method.
A further difficulty in dealing with intangibles is that these are often, sometime inappropriately, bundled with risks. Where a residual profit split method is used, the residual is often labelled "intangibles" when it may actually include registered intellectual property, know-how and risks. Care should be taken to understand and define precisely what intangibles are included in a transaction and which are not. Frequently a contribution-based profit split is more reliable and may more closely follow how independent parties share profits. In such cases, profits are often not guaranteed to an individual party for a routine function as they often can be in a residual analysis.

**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.

As TPG Para 1.23 indicates, the relevance of risk in applying the arm's length principle is that in the open market:-

- Assumption of increased risk will be compensated by increased expected return with likely increase in the volatility of that return;
- Respective levels of risks attaching to a controlled and uncontrolled transaction are relevant in determining whether they are comparable.

These considerations apply whether one is examining the application of a Traditional Transaction Method or a Transactional Profit Method.

Where unconnected parties transact business with each other assumption of risk by each of them is thus of basic significance to the establishment of the way that the pricing for the transaction will be determined and how the reward for bearing risk is effectively shared. Such considerations would be expected to be reflected in the contractual arrangements between the parties. It follows that, in applying the arm's length principle, consideration of the choice and application of an appropriate methodology should similarly follow the contractual arrangements effected by the related parties for assuming and managing risk and should not seek to ignore those arrangements or restructure those transactions except in the very limited circumstances set out in TPG Para 1.37.

This applies whether the methodology under consideration is a Traditional Transaction Method or Transactional Profit Method.

Regardless of the method employed, no adjustment to account for risk should be made unless it clearly improves the reliability of the method. Often reasonably comparable transactions are adjusted for a number of factors, with each adjustment bringing associated statistical and judgemental errors. At the extreme, a combination of adjustments may serve to create a less
reliable analysis than the original unadjusted one. Risks must be properly identified and accounted for in a manner supported by good economic reasoning but care should be taken not to completely and inappropriately re-characterise a transaction.

Frequently taxpayers are best able to understand and adjust for the risks associated with their transactions. Provided these adjustments are documented and supported with economic or commercial evidence then tax authorities should fully explore the method and risk adjustments employed before attempting to apply any other approach.

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.

It is reasonable for tax administrations to require to have made available to them the information which a taxpayer itself had available to it and relied on in determining the arm’s length nature of its pricing arrangements. However, it should be borne in mind that there is no requirement on a taxpayer to apply more than one method (TPG 1.69) and tax administrations should not expect that taxpayers will necessarily be able to satisfy requests for additional information not relevant to the method employed. So, for instance, in the case of application of the Transactional Net Margin Method in which the taxpayer is the tested party, it should not be expected that the taxpayer will be able to provide detailed information about an overseas associate with which it conducted business.

In other instances where a Transactional Profit Method has been applied to a transaction, the requirements placed on a taxpayer to provide information relating to an overseas associated enterprise with which the transaction was entered into should recognise that there may be limitations on what supplementary information can be provided by the taxpayer relating to that associate. To a large extent the difficulties in this respect are already recognised in the TPG at Paras 3.6, 5.10 and 5.11 in respect of documentation – i.e. particular information in documentary form may not be legally obtained or lack of control may inhibit the obtaining of information from an associate.
Requirements for transfer pricing information, frequently in documentary form, can already be onerous and it is important that tax administrations should be prepared to offer reasonable justification for adding to these burdens with requests for information to which a taxpayer may not have direct access. Any request for additional information should be made only after the tax authorities have conducted a detailed and empirical review of the information provided. Tax authorities should avoid placing unfair additional burdens on a taxpayer when the information provided covers the necessary points.

The issue of provision of information is far wider than one related simply to transfer pricing and it should be remembered that most tax authorities already have significant power to access information. Any further prescriptive guidance in this area could risk creating significant conflict with individual countries’ tax laws, banking secrecy laws or data protection requirements. In addition, most tax treaties contain Exchange of Information articles to enable a tax authority to seek to obtain information about a taxpayer from a treaty party in prescribed circumstances. The treaty process represents the appropriate mechanism for obtaining information in the transfer pricing area as in other areas.

The question might reasonably be posed: What information would have been available to a third party engaging in a similar transaction? Likely it would be far less than the average taxpayer currently provides in support of transfer pricing.

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

- 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?

- 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?
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?

It is recognised that determining the appropriate process of measuring the profit to be split under the Profit Split Method is one which gives rise to difficulties. However, experience suggests that it would be unwise to adopt too prescriptive an approach to resolving these difficulties – in particular since some enterprises, such as those in the financial services sector, give rise to considerations unique to their circumstances.

The most important aspect in making relevant determinations is to adopt the approach which secures most consistency as between the parties to the transaction. This may differ from one type of enterprise to another.

It may be that development of IAS will be helpful in resolving some of these issues. But one current approach which can appropriately be applied is to rely on the measurement reflected by applying the GAAP of the country of the group parent of the associates between which the transactions have taken place – which has the advantage that relevant records can be expected to exist on a consistent footing, rather than having to be created.

It may also be useful to consider profit split over a period of time as this will minimise differences in GAAP, which are often only differences in timing rather than absolute. It should be recognised that conversion into local taxable profits can cause permanent differences, which make it more challenging for taxpayers trying to balance the demands of multiple tax authorities.

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
- Whether there are cases where a contribution analysis is more reliable or appropriate than a residual analysis and if so why.
- Whether other types of approaches should be considered and if so in what cases and how they would apply.

In general terms where a residual analysis can reliably be made, this is considered to represent a more reliable and appropriate approach than a contribution analysis. Under a residual analysis the effect of the initial allocation of profit to those elements of the business relationship which it is possible to appropriately measure by reference to returns for which there are comparables has the effect of reducing the quantum of profit or narrowing down the transactional areas on which the somewhat more difficult judgement then needs to be made as to how such residual would be
divided between independents. However, it is recognised that this approach may not always be possible or appropriate where, for instance, it is clear that operations conducted between the related parties are highly integrated or are primarily concerned with the joint development and ownership of non-routine intangibles. In such a case, a contribution analysis may be more appropriate and reliable.

On occasion a residual analysis may even decrease the accuracy with which it is possible then to apply a profit split. Whether or not the residual approach is helpful will depend upon the specific transaction. Profits essentially stemming from the use of intellectual property are frequently appropriately split based on a contribution analysis as there may be few routine activities attached to exploiting such property. In addition, third parties do not always allow for routine profits in intellectual property related contracts.

An example of an arrangement in which a contribution analysis might be more appropriate is data centres used for hosting web sites or other software. In these businesses, the services offered to customers are sometimes provided by multiple entities at different times or even simultaneously. The very purpose of these operations is to offer reliable and integrated systems to support clients’ web sites. While this can be seen as a routine function in some circumstances, it could also involve some shared risks and functions, which would be more appropriately allocated adopting a profit split approach. [See further comments below in Question 8]

With either approach, judgements will need to be made and the evidence used in making these judgements should form part of the documentation support for the transaction. External evidence may be considered more objective but may not be as reliable as internal information, which may relate to the specific transaction or activity at hand.

We believe it is important to review such complex arrangements, involving multiple risks, over a number of years.

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,

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

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

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

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

• 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).

Where external data is available to assist in the process of applying the Profit Split Method this can be both relevant and useful. Such external data is not abundant but may be found in examining joint venture arrangements between unrelated parties under which profits are shared. For instance, development projects in the oil and gas industry can provide not only good evidence and guidance on how expenditures and subsequent production profits are recognised as between unrelated parties in respect of that industry, but useful evidence of arm’s length behaviour more generally. The existence of such potential sources of evidence is appropriately reflected in the TPG at Para 3.25.

Internal data may otherwise prove the most reliable means of establishing or testing the arm’s length nature of the division of profits under the method. Whilst it is difficult to be precise as to the type of such internal data, as this will depend on the nature of the activities, processes which may be seen as rationally connected with profit performance – such as the process by which a group ranks performance of its various entities and thus recognises appropriate reward – may provide useful indicators as to the arm’s length approach to determining profit allocation. A link between entity performance and senior remuneration may also create a natural tension between entities which provides comfort in determining the arm’s length nature of profit allocations.

Even where internal data is used, it is likely that judgement as to the importance of the data for the derivation of profit can generally be evidenced externally. For instance, trade journals are often found to contain non-tax articles on the impacts of certain operational or financial changes that might support the use of a particular approach or allocation key.

Using the example of data centres set out in respect of Question 7, it might be appropriate to use multiple allocation keys weighted based on the importance of the measure to the success of the service. Some of the possible allocation keys could be: fixed assets, technical personnel, number of servers, number of clients, client revenue, allocation of global contracts, amount of data stored, capital expenditure, square footage of facilities, bills paid to external telecoms providers, and likely others that technical experts could identify. Clearly issues like the need for expansion space and disaster recovery facilities will be important factors as well. The method of allocation
or split would appropriately be determined by the specifics of the transaction and the data available at the time.

It is considered that whatever approach is adopted it should be adopted consistently and independent of whether the overall result is a profit or a loss, and that it should recognise that the appropriate result may be that one entity profits while another incurs a loss.

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)?

- 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)?

The principal reason why a lower standard of comparability can be applied under the Transactional Net Margin Method than for application of a Traditional Transaction Method is precisely that recognised in TPG Para 3.43 – i.e., that the Transactional Net Margin Method applies at the operating profit level rather than the price or gross margin level. Further, the major rationale for the use of the Transactional Net Margin Method and ranges of comparable results is that the comparability standard (used here to describe the 'closeness of fit' with respect to functions, assets and risks between the tested party and potential comparables) cannot be met for the Traditional Transaction Methods. Operating profit is more tolerant of differences between products and between functions which are not reflected at the gross margin level. However, as indicated in the TPG, the resultant potential comparables must still satisfy other factors in order to be appropriately adopted – which are also already largely set out in TPG Para 3.36.

It is not considered appropriate to have regard simply to margins on a company-wide aggregated level where either the tested party or potential comparable have conducted widely differing transactions or performed widely differing functions. In such cases, in order to assure the reliability of the analysis, segmentation of results should be undertaken. It is more likely that
performing such segmentation for the tested party rather than attempting to do so in relation to potential comparables will be appropriate because of the availability of management information for the tested party and lack of such data for potential comparables. Such segmentation should only be employed where it increases the reliability of the results.

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?

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

- 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?

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

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

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

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

In general terms the method focuses on the net operating profit before deductions which are not, as such, specific to the conduct of the relevant business – including for instance, interest (other than business interest relative to financial concerns), tax and sometimes depreciation, but which can extend to exceptional items which would otherwise create an imbalance in comparability. Recently, pension costs have become a significant issue and may need special consideration as part of the application of the Transactional Net Margin Method.

We consider that the most important factor in determining the selection of a net margin indicator in applying the Transactional Net Margin Method is that it should allow for adoption of the most reliable data which can appropriately be applied. So, a measure of flexibility in choice is important in order not to exclude application of the most appropriate indicator for the individual facts and circumstances of the case.
Besides those listed in the TPG, Berry ratio, return on capital employed, invested capital, assets or equity are some further approaches that may be appropriate. The type of activities undertaken by the tested party in the transaction will determine the appropriate measure.

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 consider that, despite the increasing difficulty inherent in applying the arm's length principle, associated with the basic dependency of the principle on establishing comparable transactions between independents, it remains the appropriate approach to related party transactions for all the reasons set out in TPG Paras 1.13 and 1.14.

In order to maintain its adequacy for purpose it is essential that flexibility is an ingredient in the manner in which it is authorised for application and that it is capable of responding to the demands of business change.

Para 1.68 of the TPG is particularly welcome in this respect, in the sense that it does offer the opportunity for new approaches to be adopted in establishing prices, perhaps as a response to development of new business models, as long as such approaches satisfy the arm's length principle. Such developments tend to emerge in particular industries. A prominent example of this has been the area of global trading in the financial industry in which fees on a revenue split basis are becoming common and which can appropriately lead to recognition of losses in respect of transactions in an inefficient entity involved in the process even when, overall a profit accrues on the transactions.

Issue 12 – Other issues

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