

Reply to OECD January 2008 Issues

Notes on Transactional Profit Methods

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April 30, 2008





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Date: April 30, 2008

Re: Reply to the OECD – Issues Notes on Transactional Profit Methods dated 25 January 2008

The OECD has requested comments on the January 25, 2008 series of Issues Notes drafted by Working Party No. 6 (WP6) based on the transfer pricing experience acquired by various countries since the issuance of the 1995 OECD Guidelines and on comments received by the business community in response to the February 2006 open invitation to comment on issues related to profit based methods.

The OECD Issues Notes deal with issues posed in the May 2006 draft Issues Notes on Comparability as follows:

1. Whether the last resort status should be maintained for the transactional profit methods (covered by Issues Note #1)
2. Developing further guidance for the application of the profit based methods (covered by Issues Notes #2 to #9)
3. Considering other methods (covered by Issues Note #10)

The following are the comments and opinions of the author and are not necessarily those of Ceteris, Inc or any of its affiliated partners. The author's comments are from the perspective of his experience in dealing with practical implications of applying the profit based methods.

In general, the objective in applying any method is to determine if the controlled transaction would meet the arm's length standard. In theory the degree of comparability of the uncontrolled transaction, or companies, to the controlled transaction is the test of the arm's length principle. The more similar or comparable then the more likely the arm's length principle is being achieved. In most cases the application of any method, including the CUP Method, is, at best, an approximation of an arm's length result. In practice, it is the method that comes as close as possible to the arm's length standard that is selected.

Summary

In the author's opinion the last resort status of the transactional profit methods should be discarded in favour of the evaluation of the relative strengths and weaknesses of each method in the selection of the most appropriate transfer pricing method for a particular case. There should be no need for a continuance, in any form, of preference, as indicated in WP6's "statement of preference", for the CUP Method specifically and the traditional transaction methods generally.

The author agrees that there should be no requirement on the taxpayer to use more than one method to determine its transfer pricing for a specific type of transaction. However, it would be a best practice of taxpayers and the transfer pricing profession to consider other methods in performing risk assessments or "sanity" checks.

It is the author's experience that the presence of unique contributions by all parties to a controlled transaction, including the bearing of risk, the performance of functions, and the development and ownership of intangibles, is much more common than the situation in which one party is a limited risk entity (or perhaps more accurately characterized as having no unique contributions). Therefore the use of the profit split method (and potentially other methods that simulate the arm's length determination of prices or profit allocation) would be the more appropriate method, if appropriately applied.

As comparability is the essence of the arm's length standard, it is the author's point of view that specific guidance needs to be provided on the respective standard of comparability that would be required to apply each of the methods. This would involve similar levels of rigorous comparability analysis for each method, but with different acceptable standards for the outcomes. In addition, the transfer pricing profession should strive to establish its own professional standards (similar to the

valuations profession) to cover the professional expectations involved in undertaking a comparability analysis.

The issue with respect to the selection of the appropriate net profit margin indicator (or PLI) in the application of the TNMM is, in the author's opinion, an evolving issue. Similar to the issue of using more than one method, it would be a best practice to consider more than one PLI to evaluate the reasonableness of the range of results.

The author recommends that financial ratio analysis be utilized as part of the comparability analysis and that it should be included by the OECD in the guidance on performing a comparability analysis.

As stated above, the author's view is that the profit split method may be the most appropriate method in many cases. With reference to Michael Porter's¹ value chain concept and model, the organization has both primary and support activities (i.e., functions). The primary activities are those that add value (i.e., provide unique contributions) and any intercompany transactions involving these primary activities (e.g., inbound logistics, operations/manufacturing, outbound logistics, sales and marketing, and after-sales services) would, most likely, require the application of the profit split method. In cases involving business functions that are considered supportive of the business (for example, support activities such as HR, IT infrastructure, finance, accounting, etc.) the use of a one-sided profit method is, most likely, appropriate, as there are unlikely to be any unique contributions being made by the provider of these support services to the underlying business, related to the controlled transaction, in many industries.

The final comment is that, in the author's view, the OECD position that the taxpayer can use any other method that is not one of the recognized methods is still valid (and may be even more so). With the trend, especially in North America and Europe, of private equity firms taking public companies private, the availability of publicly available comparable companies, for the application of the TNMM, is shrinking. A couple of cases in point are the equipment leasing industry and the call centre industry (or business process outsourcing industry in general). In those cases where it is more difficult to find reliable comparables, the taxpayer may need to rely upon other methods such

as those mentioned in the Issues Note #10. There are other examples some of which relate to the use of third party methodologies in determining the pricing on intercompany financial transactions (e.g., the credit rating methodology used by the external credit rating agencies, the loan pricing models used by financial institutions, and use of finance theory in setting equipment lease payments based on WACC rates and discounted cash flow analysis). In general the OECD should issue further guidance on the use of internal (or industry accepted) pricing models that are used by the taxpayer to set its prices with independent third party customers as an acceptable methodology to determine the related party price.

These approaches are bound to create controversy, even with OECD guidance, as the tax administrations are generally not as comfortable with these methods as they require greater familiarity with respective industry practices. This is, in the author's view, the next phase in the evolution of transfer pricing; in addition to considering comparable uncontrolled transactions, the use of arm's length industry practices or methodologies to determine the arm's length transfer price for controlled transactions.

The following is the author's comments for each of the Issues Notes:

Issues Note #1: Status of transactional profit methods as last resort methods

In the OECD Guidelines the traditional transaction methods are regarded as being preferred over "other methods", such as the transactional profit methods that, as described in the Guidelines, were considered to be methods of last resort (which by definition would have limited their use to situations in which there was no reliable or insufficient comparable data to apply the preferred – traditional transaction – methods).

The author agrees with the WP6's tentative conclusion that the "exceptionality" of the use of the transactional profit methods should be removed from the Guidelines, and that greater emphasis be placed on evaluating the strengths and weaknesses of each method in selecting the most appropriate method. Therefore the transactional profit methods are not, in practice or fact, methods of last resort.

¹ Porter, Michael, "*Competitive Advantage: Creating and Sustaining Superior Performance*", 1985, Ch. 1, pp11-15, The Free Press, New York.

The other aspect of this issue is the “statement of preference” for the CUP Method (or more generally the traditional transaction methods) over the transactional profit methods. In the author’s opinion the “statement of preference” is in essence a “watering down” of WP6’s conclusion that the most appropriate transfer pricing method for each particular case, based on the evaluation of the strength and weaknesses of each method, should be selected. The last resort issue is, of course, linked to the comparability standard. As such WP6 should be providing guidance on setting an appropriate level of comparability (comparability standard) for the application of each of the methods (or at least a specific comparability standard, in general, for traditional transactional methods and for transactional profit methods).

In practice, the profit based methods are being applied on a frequent basis because the traditional transaction method has, in the judgment of the transfer pricing analyst, failed to meet the comparability standard. It is certainly the case that some tax administrations feel that the transactional profit methods are not being subjected to a thorough comparability analysis. The question is, in my opinion, a matter of what is an acceptable degree of comparability, or more precisely the acceptable methodology for making reliable comparability adjustments that would be relevant to each of the methods. As an illustration, the tested party, a manufacturer, sells similar products to its related party distributor as it sells to its third party distributor; at the same level of market and under similar economic conditions. There is, however, a major difference in the characteristics of the product that would have an impact on the price of the product (e.g., the product sold to the related party distributor has been modified to meet environmental or regulatory standards for the end-user customers of the related party distributor). As there is no guidance that has been issued on what is the acceptable methodology to make a reliable adjustment for this type of difference in comparability, a transfer pricing analyst will either develop a methodology to make the adjustment or will reject the CUP Method as the comparability adjustment can not be made in a reliable manner. Without an accepted comparability standard, the bias is likely to result in the CUP Method being rejected and another (most likely a profit based) method being selected even in those situations (after a comparability analysis) where the selected comparable companies may have other un-adjustable differences (i.e., impact of intangibles employed by each of the various comparable companies) that results in the set of comparables being relatively weak in terms of comparability.

Issues Note #2: Use of more than one method

The OECD Guidelines do not require the use of more than one method except that it is recommended that, in complex cases, more than one method could be considered. The example was to use a profit based method to supplement the use of a traditional transaction method; perhaps as a sanity check.

The OECD has requested comments on the following:

1. Instances described in Section A of the Issues Notes where a transactional profit method may be used in conjunction with a traditional transaction method. (Page 20)
2. Instances described under Section B.2 where a transactional profit method may be used as a “sanity check” to test the plausibility of the outcome of a primary method. (Page 22)

The preliminary conclusion of WP6 that the current position should be maintained as outlined in OECD Guidelines (i.e., paragraph 1.69 states that the use of more than one method for a given transaction is not a requirement under the arm’s length principle) is, in the author’s opinion, sound. As further stated it may, in certain circumstances as outlined in the Issues Notes, be advisable that a “sanity check” be performed by using a secondary method. This is, in my opinion, an example of a best practice with respect to determining or assessing a transfer pricing policy.

The circumstances where it would be advisable to use more than one method, as stated by WP6, is essentially where there is no definitive comparable for the application of a direct method (i.e., a comparable uncontrolled transaction involving a price or gross margin). In practice the comparable uncontrolled transactions are never identical to the controlled transaction. Therefore it is questionable if we would ever have a definitive comparable. Even in cases where the product characteristics are highly similar between the controlled and uncontrolled transactions, it is likely that the level of market (or position in the value chain) would be so different as to conclude that it is not a definitive comparable.

The author would like to see a more comprehensive definition of the circumstances under which it would be advisable to use more than one method. In the case where the taxpayer has several potential internal comparable transactions for the controlled transaction, the use of more than one

method would be determined by the degree of comparability before adjustments are made. In those rare cases in which comparability is high, then there would be no major adjustments required and the use of another method would be redundant and less reliable (perhaps even misleading). However, in practice, the comparables, even internal comparables, will, in some cases, require significant comparability adjustments, some of which may not be reliably quantified. This usually leads to the rejection of the direct method and acceptance of an indirect method (for reasons that have less to do with the indirect method being more reliable than the rigorous comparability analysis being applied to the direct methods).

As an example consider the case where a taxpayer is licensing certain technology and business know-how to its foreign subsidiary. If the taxpayer does not have any internal comparable agreements (which is likely the case) then a search for external licensing agreements may be performed to apply the CUP or CUT Method. In most cases the external licensing agreements will have differences, both identified as well as unrecognized, that can not be adjusted for with a high degree of reliability. While the comparability standard may not be met for the application of the CUP/CUT Method, we may obtain some comfort if the results of a second method (e.g., the profit split method) substantiate the results obtained from the external inexact comparable licensing agreements. In this example we compare the results of a residual profit split analysis in determining the arm's length royalty rate with the observed range of external licensing fees or royalties from the CUT analysis and determine if there is an overlap or convergence. In this case, the use of both the residual profit split and CUP or CUT method would be required to determine the arm's length royalty rate.

Since the consideration of the relative strengths and weaknesses of each method is the first step in selecting the most appropriate method the OECD should expand upon this issue topic in the discussion on applying the transactional profit methods. Specifically the OECD should provide guidance on what are the recognized (or most appropriate) method(s) for each type of intercompany transaction (e.g., tangible goods, provision of services, financial transactions and sale / use of intangibles) based on the relative strengths and weaknesses of the methods relative to the type of transaction. It is recognized that the selection of the most appropriate method from the recognized or other methods will depend upon the facts and circumstances of the particular case. Furthermore, as suggested above, this guidance should be inclusive of generally accepted industry practices for the pricing arm's length transactions.

As stated in the revised paragraph (OECD 3.5a), the main strength of the profit split method is that it is a solution to the problem raised in dealing with the economic impact of unique and valuable intangibles. In most cases a direct method is likely not to have sufficient or reliable data (comparable transactions or comparable companies) and would, in most cases, be rejected. The other case, as cited, is where the operations are highly integrated such that a one-sided method is likely not the most appropriate method. With limited exceptions the operations of a large MNE are most likely to always be highly integrated and employ unique (and potentially valuable) intangibles. A MNE is likely to have multiple transactions and relationships with suppliers, vendors and other stakeholders. Based on economic theory the parties to a business arrangement would consider the present value of the expected future cash flows over the expected life of the arrangement and not on a one-period basis. Therefore in determining an arm's length profit split the entire expected time frame of the arrangement must be considered and not just the current period's circumstances.

In these cases, and where multiple sources of comparable data exist, then it is prudent to use all available data in determining the arm's length price.

Issues Note #3: Access to the information needed to apply or review the application of a transactional profit method.

The author agrees that access to reliable data or other information that is needed to apply the transfer pricing method is critical. In other words, if the taxpayer or tax administration is unable to find the required information it can not use, or apply, a particular method that would require such information. If transactional data or information at the net margin level is not available, the taxpayer would need to consider other methods. As noted, this issue note is closely related to the documentation issue raised in the May 2006 Issues Notes on Comparability and, as such, can not be properly treated in isolation.

Issues Note #4: Application of transactional profit methods and unique contributions

In this context, "unique contributions" refer to non-benchmarkable functions, assets or risks for which there are no sufficiently reliable comparable data available. While the OECD states that it is not desirable to have a prescriptive list of the transactions that would involve unique contributions, it would be, in the author's opinion, beneficial for more illustrations in the revised guidelines of the

impact of unique contributions on the selection and application of each method. While the author agrees that the determination of the existence of unique contributions is based on the facts and circumstances, it would be, from a practical point of view, of much more assistance if a non-exhaustive list was provided as guidance of when unique and valuable intangibles are involved in the transaction. Given the importance of this issue, the OECD states that, with a thorough comparability analysis, the taxpayer and tax administrator must identify the unique contributions. In theory, functions can be benchmarked except in those cases where there are embedded valuable and significant intangibles within the functions that are value drivers. In practice, we observe that every public (i.e., for profit) enterprise has some form of organizational intangible or business model (at a minimum) that is a value or profit driver (or potentially could create profit or value). Otherwise the enterprise is unlikely to be a public enterprise, as it would not be able to continue to attract investors. Almost by definition all public company comparables will have some level of unique intangibles (and therefore unique contributions to a controlled transaction). This is an issue when performing a comparability analysis in the application of a one-sided profit based method like the TNMM.

The unique contribution of risks by the parties to the controlled transaction is based on the identification of the major economic risks by looking at the contractual terms (usually in the form of a written agreement or alternatively based on the intent of the parties). These risks should be real and reflect how arm's length parties would allocate risks between themselves in the transaction. Lastly the parties' conduct needs to conform to the terms of the contract (or prior intent of the parties).

The OECD identified some transactions that have comparability difficulties due to lack of comparables for the unique contributions or due to a lack of third party financial information on the third party's unique contributions i.e., functions with embedded intangibles, IP ownership or allocation of major economic risks.

The OECD looked at the application of the profit split method in dealing with unique contributions and observed that in practice the profit split is determined by some indicator that reflects each party's investment in the acquisition, creation or development of the intangibles involved in the transaction. However, "unique contributions" involve more than just intangibles. The assessment of unique contributions is made even more difficult because the unique contributions involve risks (and sometimes specialized or unique functions) as well as intangibles.

There are more difficulties when attempting to use the TNMM for transactions involving intangibles. In fact, as OECD states, the TNMM is unlikely to be reliable in situations where both parties to the transaction have contributed unique intangibles (or more generally unique contributions). In the author's point of view the use of the TNMM is predicated on the assumption that the tested party is not making any unique contributions to the transaction. Except in the rare cases in which the tested party is a limited risk entity (or to be more precise does not provide any unique contributions of intangibles, function or risks; is a "non-unique contribution" entity) applying the TNMM in those cases where both parties are making unique contributions would have some serious comparability issues. It would seem highly unlikely that enterprises, especially publicly traded companies, as stated elsewhere in this reply, would not have some level of unique contributions. As public entities are established as profit maximizing entities the ability to do so requires unique contributions in forming a competitive advantage. It begs the question of whether or not we would ever find a public company that was a truly a limited-risk entity.

In the author's view the TNMM can not be applied (on a reliable basis) where both parties have valuable intangibles and by extension unique contributions. There is also a good argument that it would not be reliable for a transaction involving the licensing of an intangible unless, at least potentially, we are benchmarking the net margin of an IP holding company that hold patents or trademarks (etc.) that are comparable to the controlled transaction and generate an income stream from licensing the technology. This is further complicated as it would likely not be transactional but would be the result from the portfolio of technology licensing activity.

The OECD should specify that the TNMM would not be an appropriate method for the determination of the licensing of intangibles. In the absence of internal or external comparable licensing agreements, the profit split method is the only OECD recognized (transactional profit) method that would be appropriate. As indicated below there are other methods or techniques, that arm's length parties would apply in determining the royalty rate (i.e., discounted cash flow or DCF), which could be applied in addition to the OECD recognized methods to provide an arm's length result.

Issues Note #5: Application of the TNMM: Standard of comparability

In the author's opinion the standard of comparability is the most significant issue in the application of the TNMM. While paragraph 3.34 of the OECD Guidelines outlines the general comparability standard, there are many practical difficulties in meeting the comparability standard. This is highlighted by WP6 questions: *"To what extent can a lower standard be applied in the TNMM than in the traditional methods? Why and for what reasons?"*

As stated in the OECD Guidelines, the application of the traditional transaction methods requires a relatively higher degree of comparability than for the application of the transactional profit methods, in particular the TNMM. Since we are considering the same five comparability factors (5CF) we should, however, apply a different comparability standard for each of the 5CF when applying them to specific methods. For example the product characteristics would need to have a high degree of comparability to apply the CUP Method relative to the TNMM.

From a practical standpoint the TNMM is being selected as the most appropriate method because the other methods (i.e., traditional transaction methods) did not meet the comparability standard. The OECD should publish guidance on what constitutes a "sufficiently reliable" comparability analysis for each and every OECD recognized method. In most cases the use of the TNMM requires a practical relaxing of the degree of comparability but not necessarily the comparability standard (or rigorous application of a comparability analysis). As stated above, we should recognize that we are attempting to approximate the arm's length principle, i.e., the highest level of comparability, and not necessarily trying to reach or achieve full comparability.

It is not surprising that even after screening the comparables based on the functional analysis there is a wide dispersion of results for the set of comparables. In most cases if we were to apply the comparability standard we would likely not accept many (if any) of the comparable companies and this result is neither a practical or helpful conclusion. The real question is: *"What should the comparability standard be for application of the TNMM?"*

Another question posed by the WP6 is: *"To what extent do you consider the TNMM can be validly applied using company-wide aggregated data (either on third party comparables or on the taxpayer's net margin)?"*

In the author's view the answer is different depending upon whether we are considering the comparables or the tested party. As it is, by definition, a transactional method, the TNMM would need to consider the transactional data of the tested party and not the company-wide data to apply this method. The answer is different for the use of company-wide data from comparable third party companies. In most cases it is difficult if not impossible to obtain reliable financial data on the comparable companies on a transactional basis even if these comparable companies reported segmented financial / business information. Therefore the search for comparable companies is for companies that meet the standard of functional comparability with the tested party and not to meet the transactional nature of the TNMM.

In most cases it is not appropriate to use company-wide data for the tested party but certainly could be appropriate to look at business line data that is functionally comparable with the comparable companies. The other factor is the significance or impact that the intercompany transactions have on the tested party. For example if we consider the example of Ford Motor Canada² in which the intercompany product flows in a non-arm's length transaction had a significant impact on profitability. At the other extreme is the transfer of a tangible product that is only a relatively small part of the tested party's business. In the case where the controlled transaction is relatively insignificant to the overall profit of the tested party the only effective way is to test it on a transactional basis but as the significance of the controlled transaction increases then the aggregation of data increases until it is in essence company-wide.

The last questions posed by the WP6 are: *"To what extent can a lower standard for aggregating transactions be applied in the TNMM than in a traditional transaction method? Why and for what reason?"*

The process of applying the TNMM should be one that starts with the highest level of comparability, and if reliable data is not available at that level the standard should be relaxed. To use the TNMM would imply that the traditional transaction methods were not appropriate and that the profit split could not be applied. Therefore the comparability standard would need to be relaxed in order to determine the transfer pricing using the TNMM.

² Ford Motor Co. of Canada v. OMERS. Court of Appeal for Ontario, No. C41312

In the author's view the profit split method is the most appropriate profit based method. It replicates the process by which parties would look to allocate profits from a business arrangement or transaction. If a manufacturer is in the process of determining the allocation of profits to its distributor it will go through a process of evaluating the economic conditions as well as the cost structure of the distributor. In essence the trade discount provided (or commission paid) to the distributor is a function of what it would cost the manufacturer to perform these functions themselves compared to the added value creation by outsourcing this function to an independent distributor.

The author agrees with the conclusion that the OECD Guidance on comparability needs to be theoretically sound but also practically workable.

Issues Note #6: Application of the TNMM: Selection and determination of the net profit margin indicator (PLI)

There is no definition of "net profit margin" in the OECD Guidelines. As stated there is only general guidance on the net profit margin indicator (or PLI) which is in relation to a return on sales, assets, costs or some other measure. Since there is no definition in the OECD Guidelines it is important to consider what is the "net profit margin".

In determining what is "net profit margin" the type of expenses that should be deducted from the revenues are, in theory, determined by the functional analysis but are, in practical terms, restricted by the availability of sufficiently reliable financial data on these expenses (i.e., for the comparable companies the expenses are generally aggregated).

The main factors influencing the selection of the most appropriate PLI are stated as:

1. The PLI's relevance to the circumstances of the case with particular reference to the industry and the comparability analysis (which included the functional analysis and value drivers of the transaction under review).
2. The availability of information especially on the uncontrolled transaction or comparable company to make a meaningful and reliable comparison on the basis of the selected PLI.

In the author's opinion the availability of sufficiently reliable information or financial data is the main consideration. As such, it is no surprise that the operating margin (OM) is the most used PLI as sales and operating profit data are much easier to obtain (and arguably the most reliable and accurate) on the comparable companies. Due to the interrelatedness of the various PLI (as demonstrated in the Dupont formula³) it is less important to look at the relevance of one PLI over another but to what each PLI can reveal about the arm's length allocation of net profit.

The WP6 position on the appropriate use of the Berry ratio is, in the author's opinion, well stated. However the author would disagree that the arm's length remuneration for selling activities, especially at different levels of market, should always be a sales-based margin. For example, in commodity trading operations the operating profit is sensitive to changes in volumes and commodity prices, as well as the use of derivatives in a hedging program.

In a comparability analysis the use of a financial ratio analysis would provide some insights into the comparability of the comparable companies to the tested entity. For example if a comparable company has a ROA that is significantly different from the other comparables in the set it would need to be investigated and either some comparability adjustments performed or the comparable would need to be removed from the set. The author recommends that a financial ratio analysis be included as part of the methodology for an effective comparability analysis.

In the selection of uncontrolled transactions or companies in a comparability analysis we would need some additional guidance from OECD. In cases where we have clearly identified and confirmed that a major comparability defect exists for a transaction, or company, for which we can not make a reliable adjustment, we must reject the transaction or company. However, in those situations, in which we can not identify any comparability defects due to lack of available information on the comparability factors (in particular the functional comparability), we would not have the necessary information to decide on whether or not to reject the comparable.

With respect to the issue of whether or not certain costs should be treated as a pass-through by the tested party there is rarely a situation in which an arm's length party would not look to generating a

³ The Dupont formula is a financial analysis technique that integrates data of the balance sheet and the income statement to determine the return on equity (ROE). The ROE consists of product of three components: the next margin, asset turnover, and financial leverage.

profit on outsourced functions. In the extreme there are companies that generate profits from outsourcing most (if not all) of the business functions to third parties. Pass-through treatment of third party costs would have very limited application.

Issues Note #7: Application of a transactional profit split method: Determining the combined profit to be split

As stated there is little guidance in the OECD Guidelines on how to determine the combined profit attributable to the controlled transaction.

The WP6 discusses two main types of issues with respect to determining the combined profit:

1. Lack of harmonized accounting standards; and
2. Selection of the appropriate profit measure (gross or net profit) for the combined profit to be split.

In the author's opinion, the problem that arises as a result of a lack of harmonized accounting standards being used by the related parties to the controlled transaction is less of an issue in the profit split method (and specifically in determining the combined profit to be split) than it is in dealing with accounting standards used by third party companies in applying the TNMM (or arguably in the cost plus or resale price methods). In applying the profit split method the accounting issue with respect to determining the combined profit is an exercise of making sure that the accounts of all parties to the controlled transaction be put on a common basis from an accounting (and currency) basis. This is (relatively) easier to achieve for entities that are within the same group than it is for external comparable companies. Certainly in the application of the residual profit split approach, in which the TNMM is used to benchmark the routine returns, the lack of harmonized accounting standards would be an issue that impacts on a portion of the analysis.

While the WP6 does not provide a prescriptive answer to choosing an accounting standard it is probably sufficient to state that the same accounting rules (either financial or cost accounting) be selected by the parties in advance of entering into the arrangement and are consistently applied throughout the term of the arrangement. The OECD should, however, issue guidelines that indicate

that a tax administration should not question the selection by the taxpayer of a consistently applied accounting standard to the profit split method and should not attempt to restate the arrangement into the accounting standards used in their jurisdiction.

As stated above there are different measures of profit that could be considered to determine the combined profit; gross profit, operating profit or some hybrid of the two. The objective of the profit split method is to determine how independent parties would agree on a split of the profits earned from the business arrangement. The selection of the type of profit to be split must be consistent with the facts and circumstances of the case. For example in an energy or commodity trading operation the profit that is generated by the business arrangement between the parties is the net trading profit (as defined by the parties based on an agreed upon accounting treatment). In this example the net trading losses in a prior period would be brought forward into the calculation of the net trading profit to be split in the current year which may, or may not, be consistent with the accounting rules.

In practice the operating profit is usually the measure of the combined profit but there are cases where the gross profit (such as the example above with net trading profit being a form of gross profit) could be split between the parties. The OECD Guidelines 3.17 gives an example of a highly integrated world-wide trading operation as a case in which the gross profit would be split. WP6 has requested comments on whether or not the example is still to be regarded as valid. In the author's opinion the example is still valid however it would be worthwhile, given the concerns by some commentators, to expand upon the example. In addition the author wonders if the use of a gross margin (or some hybrid between gross and operating) is more likely to be the measure that independent parties would consider in their negotiations of a specific business arrangements (such as what is observed in joint venture agreements – see Issues Note #10 below).

The illustrative examples provided by WP6 in this section on the use of the operating or gross profit as the measure of the combined profit to be used in the profit split method indicate that the results from the use of an allocation key based on the relative costs of the parties is indifferent if applied before or after these costs are deducted. What is missing in this illustrative example is the impact of the allocation of risks to the parties in determining the profit split. In the example the entire residual profit is attributed to the intangibles. There should be a disclaimer to the example to indicate that it is only illustrating the point that if the costs are used as the allocation key then it does not matter if the combined profit is determined before or after the costs are deducted.

It is important to re-emphasize that it is critical to consider the allocation of risks between the parties in the context of applying the profit split method. In a residual and contribution analyses (see Issues Notes #8 and #9 below) the unique contributions by the parties to the controlled transaction must be evaluated to determine the profit (or loss) split. The same principles that are applied to profit split must be applied to loss split. This would suggest, from the author's perspective, that the residual profit split approach may be less helpful than a full contributory profit split approach (which takes into account all of the unique contributions). For example if we assume that the assumption of a specific risk (say market risk) is mainly with one party (say at a relative contribution of 90% / 10%) and that the reason for the operating loss arising from the controlled transaction is due to the economic impact of a downturn in the local market then the party that assumes the (majority of the) risk must bear most, or all, of the loss even if the other party(ies) may make a profit on the controlled transaction. The profit split method should generate this arm's length result which is consistent with the allocation of risks between the parties.

Another issue (as stated in 183 of the Issues Notes) is how the transfer price will be treated for tax purposes from the application of the profit split method. Notwithstanding that each domestic taxing authority would have its own way in which it would tax the profits, the characteristics of the controlled transaction would be based on the business arrangement, i.e., is it a formal joint venture arrangement in which the profit split is the manner in which the parties earn the profits or is the profit split method only a mechanism to simulate the negotiations underlying the setting of a transfer price for the goods and/or services and/or use of intangibles). In the former situation the intercompany transaction is the share of the profits and in the latter situation it is not a share of the profit but a transfer price that is derived from the profit split analysis. Therefore it would be, in substance, a price paid for the transfer of the tangible property, or a charge for provision of services, or a royalty rate for the use of the intangibles. As the profit split method is an attempt to replicate the arm's length determination of the transfer price (*ex ante*) it should not be applied to test the results (*ex post*) of the transfer price (unless the underlying assumptions or data used in setting the transfer price were, in fact, not representative of what arm's length parties would have agreed to).

Issues Note #8: Reliability of residual analysis and contribution analysis

In applying the profit split method, in the author's opinion, the taxpayer should go through a methodology that asks the question: "*In the controlled transaction under review are there any*

functions with related risks and intangibles or other assets that can be benchmarked?” If the answer is no then the taxpayer would perform a contribution analysis; if yes the taxpayer would use the residual analysis and approach. In essence the contribution analysis is the profit split method applied in those cases where there are no benchmarkable functions.

In general, the author agrees with the conclusion of WP6 with respect to those cases in which a full contribution analysis should be made based on the combined profit and with respect to those cases in which a residual analysis is more reliable. Given an example where there are two parties to the controlled transaction; one is the manufacturer and the other is the distributor. If the manufacturing function can be benchmarked including all of the associated manufacturing intangibles and likewise if the distribution function can be benchmarked then, at least in theory, the combined profit from the controlled transaction would be fully accounted for. If there is a residual then this may be evidence that there are other non-benchmarkable intangibles or risks that are contributing to the residual profit. In this case a residual analysis would look to split the residual profit between the parties. The full contribution analysis is more reliable if there are no reliable third party data to benchmark the functions.

As stated by WP6 the exercise of determining the benchmarkable returns may suggest that these are a “preferred return” to the controlled transaction. This may not be the situation, however, and, as such, it must be consistent with the comparability (including functional) analysis. Could the party that provides a benchmarkable function incur a loss on that activity? It is very rare occurrence that an economic analysis of manufacturer or distributor comparable companies would produce an inter-quartile range with a loss (although it may exist in the full range) and even less so if a multi-year averaging technique is employed.

Issues Note #9: How to split the combined profit

While this Issues Note is in reference to the combined profit, it should also take into consideration how to split the residual profit. Since the approach is the same, i.e., determining the relative value of the contributions made by the parties to the controlled transaction, the author’s comments are considering how to split the residual profit as well as the combined profit.

The residual profit is, by definition, the profit that is not attributable to any benchmarkable functions, risk or intangibles. Accordingly the first step is to identify all of the unique contributions

that the parties are making to the controlled transaction. The next step is to assign a relative significance or importance of each unique contribution to generating the residual profit. The third step is to determine the relative contribution of each party for each of the unique contributions. The final step is to select and apply an appropriate allocation key for each type of unique contribution. The following is an abbreviated example involving Party 1 that manufactures components and sells them to Party 2 which performed some value-added manufacturing, distributes the products, and provides after-sale service in its local market.

The following table may be helpful to illustrate the example.

Unique Contributions	Relative contribution of Party 1	Relative contribution of Party 2	Relative significance to generate residual profit in year under review
Unique intangibles			
1. Marketing intangibles (trademarks, trade names)	100%	0%	15%
2. Marketing intangibles consisting of customer contracts / relationships	10%	90%	25%
3. Software related intangible used in technical processes (after-sale service)	100%	0%	5%
Unique risks			
1. Related to local market demand that is specific to this business	5%	95%	50%
2. Related to the software development and value	95%	5%	5%
Unique functions			
None identified	0%	0%	0%

The example is not being provided to demonstrate the profit split calculation but rather to show that, in most cases, there will be a number of unique contributions being made that would account for the residual profit. The comparability (including the functional) analysis would provide a framework to ascertain the relative contributions of the two parties with respect to the unique contributions and also the relative significance or importance of the unique contributions as value drivers in the controlled transaction under review in any particular year (or period).

In certain situations it may be possible to find some external data on how parties would split profits arising from a transaction in which each party contributes a set of unique contributions. The most notable source of external data is the use of joint venture agreements between unrelated parties. Another example is the implied profit split in the hedge fund or venture capital industry (from the profit incentive fee or carried interest earned by the hedge fund manager) in which one party would make the unique contribution of assuming all of the significant business risks and the other party would provide the unique contribution of their expertise and knowledge in running the business. In general, it is, however, very difficult to find sufficiently reliable external data to make a split of the residual profit by reference to a single allocation key.

There are other external sources of data that could be considered, as stated in the Issues Notes, such as external pricing models developed by third party consultants (e.g., pricing models for specific distribution channels), other pricing models that are commonly employed in certain industries (e.g., credit risk and loan pricing models), franchise agreements, and licensing agreements that have pricing which is based on a profit-sharing formula.

The general requirements discussion by WP6 on the allocation keys that could be used to split combined profit is a step in the right direction. However there is need for more comprehensive guidance on the methodology along with more illustrative examples.

The issue of proper identification of the intangibles that could be employed in the controlled transaction is difficult. The OECD should provide a more detailed methodology to identify and determine which entity (economically and beneficially) owns the intangibles and whether or not the intangibles are significant to the controlled transaction.

The WP6 indicates that usually taxpayers select the profit split method due to the fact there is no reliable external data available to apply any of the other recognized methods. In the author's experience, and while this may be true for the information or data that is necessary to apply the TNMM (or traditional transaction methods), it does not necessarily apply to the profit split method as the type of external data required for the application of the profit split method can be distinct from other external data used in the TNMM or traditional transaction methods.

Issues Note #10: Other Methods

In the event that the taxpayer is unable to apply any of the OECD recognized methods, the author agrees with WP6 that the taxpayer should be permitted to apply any other reliable method to solve its transfer pricing problem. In the author's opinion these other methods should, in all cases should be considered a best practice, in performing an analysis that is required for an OECD recognized method or as a further sanity check to an OECD recognized method that is based on comparable data that does not provide a definitive comparable.

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