

## **Transactional profits transfer pricing methods**

Comments on a series of draft issues notes

30 April 2008

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## 1. Summary of key points

1. Abolishing the exceptional status of transactional profit methods and introducing a “most appropriate method” analysis is a welcome step towards the alignment of the Guidelines with the practical realities of implementing the arm’s length principle.
2. The use of a transactional profit method to corroborate or “sanity check” the results of transactional method analysis is helpful, particularly for large and complex transactions. But there should be no requirement to apply multiple methods.
3. Ernst & Young strongly recommends to extend the discussion of how the transactional profit split method can be implemented. In particular, a consensus is needed on how to deal with very complex cases with multiple non-routine contributions for which no obvious objective allocation key exists.
4. Given the limited information available on royalty rates for third party transactions, it is inevitable that TNMM will play an important role in setting license fees when only one party to the transaction is making a non-routine contribution.
5. When the traditional transactional methods cannot be reliably applied and only one party is making a non-routine contribution, TNMM is likely to be the most appropriate method. In applying TNMM reasonable endeavors should be used to undertake comparability analysis. However, it must be recognized that only limited information is often available. If comparability standards are set too high, no OECD method will be capable of being reliably applied.
6. The calculation of net margins raises a range of complex issues. Dealing with them in practice may be difficult and expensive. It is important to recognize that the guiding principle should be whether the reliability of the analysis is likely to be increased.
7. More detailed consideration might be given to the question of when (if at all) a Berry ratio is appropriate to reward sales activities. More generally, the Working Party might wish to consider when fees rather than performance related reward structures are appropriate bases for pricing related party transactions.
8. Ernst & Young strongly recommends that the Working Party gives more detailed consideration to its view that return on asset/capital financial indicators should only be used when asset values can be shown to approximate to market values.

## **2. Review of transactional profit methods: status as last resort methods**

In this Issues note, Working Party 6 (“WP6”):

- Reports its tentative conclusion that the exceptional status of transactional profit methods should be abolished.
- Advocates a structured analysis leading to a conclusion on the “most appropriate method”, subject to a presumption that, other things being equal, a traditional transactional method is to be preferred.
- Proposes specific consequential changes to the Guidelines.

### **2.1 Abolition of exceptional status of transactional profit methods**

In response to earlier consultations, Ernst & Young has reported its overwhelming experience that it is very often not possible to apply the traditional transactional methods; and that, consequently, a gap has opened up between the guidance in the OECD’s Guidelines and day to day practice.

Ernst & Young therefore welcomes this change.

### **2.2 Most appropriate method analysis**

Moreover, Ernst & Young recognizes that:

- There will be occasions on which the traditional methods can be reliably applied and others when scrutiny of information on the terms of unrelated party transactions will provide helpful information which should be taken into account alongside other comparability data.
- Transactional profit methods are themselves subject to deficiencies.

Ernst & Young therefore also believes that the notion of a “most appropriate method analysis” based on all relevant facts and circumstances and the available comparability information is a helpful one.

### **2.3 Specific changes to Guidelines**

Ernst & Young agrees with the proposed changes.

### **3. Use of more than one method**

In this Issues note, WP6:

- Reaffirms existing guidance that the application of more than one method, while it may be useful in some cases, is not a requirement.
- Explores circumstances in which the application of a transactional profit method together with a traditional transactional method may indeed be useful.
- Discusses the use of a “sanity check” to test the results of a primary method.
- Proposes certain specific changes to the Guidelines.

#### **3.1 Adherence to existing guidance on use of multiple methods**

Ernst & Young agrees with this conclusion. A requirement to apply multiple methods would increase compliance costs.

#### **3.2 Use of a transactional profit method together with a traditional transactional method**

Ernst & Young’s experience is that the limitations on the information needed to undertake a comparability analysis together with comparability imperfections mean that use of multiple methods and data for large and complex transactions is desirable. For smaller and simpler transactions, the associated compliance costs would not be justified.

#### **3.3 Sanity checks**

It is unclear how a sanity check is to be distinguished from the application of a second method to refine or corroborate the results obtained from a primary method. One possible distinction is in the level of analysis performed. For example, a sanity check on the application of the CUP method might involve a judgment based on experience as to the reasonableness of the resulting operating margin realized by the simpler party to the transaction. If the sanity check is passed, no further action is taken; if it is not, the application of another method is considered. An alternative (which appears to be more consistent with the proposed drafting changes) is that there is a difference in motivation. That is, the purpose of a sanity check is to assess the reasonableness of the primary method.

However, on either definition, sanity checks are simply good practice. A method cannot be “appropriate” if it yields a result that would not be acceptable at arm’s length. (For example, if it results in recurring losses for one party.) Whether it is necessary to go further and give formal status to sanity checks must be in doubt, although little would be lost if it is felt necessary to do so in order to make clear that analysis leading to improbable results needs further consideration.

#### **3.4 Proposed changes to Guidelines**

As already observed, the difference between a sanity check and the application of a secondary method is unclear.

## **4. Access to the information needed to apply or review the application of a transactional profit method**

In this Issues note, WP6 considers two, relatively narrow points relating to the difficult question of information availability:

- Requests by tax administrations for information on a foreign associated enterprise for the purposes of reviewing the application of a transactional profit method and, in particular, whether tax authorities should be able to request more information than would be available to the domestic entity if the parties were unrelated.
- Requests by tax authorities for information on management or cost accounting.

### **4.1 Request for information on a foreign associated enterprise**

The application of transactional profit methods inherently involves the use of information that would likely not be available to the domestic entity if the foreign associate is the tested party; or if a transactional profit split approach is adopted. Moreover, it is likely that information that would not be readily available at arm's length is needed to undertake a comparability analysis when applying a traditional transactional method.

Ernst & Young therefore believes that it is necessary to recognize that in application of the profit split method the arm's length principle cannot be extended to the point at which it is to be assumed that the parties (only) have the information that would be available to independents. If the arm's length principle is taken to this limit, the OECD transfer pricing profit split methods cannot be applied.

The information which it is assumed to be available to the parties raises complex issues going well beyond the scope of these issues notes. However, the question here is confined to the availability of the information necessary to apply and review the application of a transactional profit method.

Ernst & Young accepts that tax authorities need, within reasonable limits, to have access to qualitative and financial information to the extent that this is necessary to review the application of a transactional profit method. As the discussion in the Issues note recognize, access to information may not always be needed; and there are practical issues concerning availability.

### **4.2 Request for information on management and cost accounting**

Ernst & Young recognizes that segregated accounting information and information on cost allocations is often necessary to successfully implement transactional profit methods.

## **5. Application of transactional profit methods and unique contributions**

In this Issues note WP6 considers:

- When a transactional profit split method is appropriate in cases involving unique contributions.
- How to apply the transactional profit split method in such cases.
- When TNMM may be the most appropriate method.
- The use of TNMM to price a license fee for an intangible.

### **5.1 Conditions for the application of the transactional profit split method**

The discussion essentially confirms existing guidance that the residual profit split method is suited to cases in which both parties make non-routine contributions that are hard to value using benchmarking techniques.

This much is common ground. As discussed in greater detail below, the challenge is to develop profit split approaches which can accommodate the complexity of business today.

### **5.2 Application of the transactional profit split method**

The discussion here again essentially restates current guidance. However, it omits reference to two approaches which it is our understanding are consistent with current guidance:

- 1) The use of bargaining theory to define an “arm’s length range”.
- 2) The use of contribution analysis in a structured framework which (in effect) quantifies the contribution of economically valuable functions and then (in a second stage of analysis) quantifies the value of the contributions of the parties to the transactions.

Bargaining theory is referred to in Para 3.21 of the Guidelines and Para 3.18 refers to contribution analysis. This latter point is further discussed in our comments on Issues note 9.

We have found these approaches helpful in dealing with very complex circumstances which cannot be addressed by more conventional techniques. Ernst & Young recommends that the Working Party considers providing guidance on these and other techniques.

### **5.3 Application of the TNMM**

Ernst & Young agrees with the discussion on when the TNMM may be applied when one party makes a unique contribution.

### **5.4 Use of TNMM to price an intangible**

The discussion recognizes that TNMM is sometimes used to price intangibles on a residual basis but falls short of endorsing the approach. Rather the discussion appears to envisage the use of TNMM as a sanity check. At the same time, the discussion also acknowledges the deficiencies of a number of other approaches that the practitioner will consider.

When other methods are available and can be reliably applied, Ernst & Young would agree with this view. However, it is necessary to price intangibles somehow and TNMM is sometimes the only available approach.

Ernst & Young notes that in some countries variable royalty rates based on licensee performance are not observed at arm's length. Ernst & Young's view is that the application of a variable royalty rate is not necessarily intended to mimic arm's length behavior. Rather the objective is to yield an arm's length result over a run of years.

## 6. Application of the transactional net margin method: standard of comparability

In this Issues note, WP6 considers comparability issues in relation to the application of TNMM including the use of company wide data to generate financial benchmarks.

### 6.1 Comparability and TNMM: general considerations

Ernst & Young agrees with the discussion. TNMM is less sensitive to comparability differences and can therefore be applied when other methods could not. For example, it is rarely possible to evaluate the applicability of the resale price method using external comparables even in countries in which gross margins are disclosed in published accounts.

In Ernst & Young's view, the quote in Para 94 is key. A case by case approach is essential guided by a requirement to use reasonable endeavors to identify and evaluate data relevant to the comparability analysis and to the selection of the most appropriate method.

However, the difficulty of obtaining comparability information at acceptable cost is a key learning point from our experience since the 1995 Guidelines were published. If the bar for acceptable levels of comparability and comparability analysis is set too high neither the TNMM nor the traditional transactional methods can be applied "reliably". Since (wholly correctly in Ernst & Young's view) the Working Party is confirming that the profit split method is to be reserved for cases in which both parties make valuable, unique contributions, it follows that a pragmatic approach to comparability should be taken.

### 6.2 Aggregation

The level of disaggregation adopted for an analysis is a key decision. While subject to the adoption of a portfolio strategy, a transactional approach is desirable, it should be recognized that little is gained because of:

- The limitations of the available benchmarks
- The inherent complexity and ultimately arbitrary nature of overhead cost allocations

## **7. Application of the transactional net margin method: selection and determination of the net profit margin indicator**

In this issue note WP6 discusses:

- Measurement of net margin
- Choice of PLIs for TNMM

### **7.1 Measurement of net margin**

It is stated that when calculating net profit margin indicator non-recurring items in general, direct tax and interest income and expense other than on trade receivables and payable should be excluded. On the other hand the profit margin should include interest income or working capital adjustment should be considered if financial terms affect prices. Analysis of foreign exchange of a trading nature should also be performed.

Other areas to consider when determining net profit margin include amortization and depreciation. The paper includes suggestions of a leaning towards EBITDA for non-asset intensive industries.

Stock options are also recognized to be a form of remuneration that should be included in operating margin. However, valuation issues in comparables may lead to a rejection of stock options as part of a net profit margin indicator.

Ernst & Young accepts that some analysis should be made to financial data of tested party and comparables in order to ensure comparability. This is, however, often difficult due to lack of appropriate information. This may be particularly true for remuneration cost adjustments. Additionally, extensive analysis may be costly and not reliable. Ernst & Young believes that the effort to adjust the net margin should only be undertaken if it is likely to yield a more reliable result.

### **7.2 Choice of PLIs for TNMM**

The choice of appropriate PLIs should be influenced by a comparability analysis focusing on the allocation of risk and value drivers. It should also ensure reliability of measurement.

Ernst & Young notes the Working Party's view that the Berry ratio should only be used to reward sales activities; and that a sales related indicator is more appropriate except in comparable situations when independent parties operating at arm's length would have agreed otherwise.

Ernst & Young believes that the case can be made for the use of a Berry ratio in some cases in highly integrated groups in which the "selling" is predominantly undertaken at a regional or global level and the sales company's functional is largely logistical.

Perhaps more deeply, it may be appropriate to explore the circumstances in which fees rather than performance related reward structures are appropriate.

In particular suggestion has been made to include intangible as well as tangible operating assets when using ROA as PLI. This is probably of limited importance in the case of TNMM.

Ernst & Young disagrees with the Working Party's view that return of assets/capital financial indicators should only be used when the market value of assets can be determined "in a reasonably reliable manner". There are a number of problems with this viewpoint including:

a) The appropriate basis for assessing market values is unclear in a related party context given that valuations are often based on projected earnings which depend on the transfer pricing policy adopted. Replacement cost might be more promising but can be very difficult to determine in the face of technical progress;

b) Adoption of this position would normally rule out the use of asset intensity adjustments for differences in production techniques

c) In asset intensive industries it is far from clear that other methods or financial indicators are available

Ernst & Young therefore strongly recommends that the Working Party give more detailed consideration to this issue.

## **8. Application of the transactional profit split method: determining the combined profit to be split**

In this issue note WP6 discusses:

- Application of accounting standards
- Net vs. gross profits.

### **8.1 Application of accounting standards**

Standards adopted should be chosen in advance, applied consistently over the life of the arrangement and documented properly. Cost accounts should be capable of being used and auditable. In order to implement the profit split method a joint-venture or partnership agreement should be concluded and the price set to target profit split.

Ernst & Young recognizes that reliable information on cost allocations as well as consistency in accounting standards is necessary to successfully implement the transactional profit split method.

### **8.2 Net vs. gross profits**

Ernst & Young agrees that the determination of the profit to be split depends on the facts and circumstances including the availability of comparable external data. The suggestion that a measure between gross and net profit maybe appropriate in certain circumstances is helpful. For example, we agree that it may well be appropriate for the parties to bear their own corporate overheads rather than implicitly to share these costs.

## **9. Transactional profit split method: reliability of a residual analysis and a contribution analysis**

In this issue note WP6 considers the circumstances under which residual and contribution analysis may be reliable.

Ernst & Young agrees with the conclusion that no hard or fast rule is appropriate. Residual analysis becomes more reliable when contribution analysis can be benchmarked properly. This may, however, result in the functions that are benchmarked getting a preferential claim. When no benchmarks or third party profit split data is available, a contribution approach becomes more reliable.

## 10. Application of a transactional profit split method: how to split combined profit

In this Issues note WP6:

- Suggests some changes to three Paras in the Guidelines dealing with the transactional profit split method
- Defines criteria which allocation keys should meet
- Presents a discussion on allocation keys
- Discusses the role of external and internal data to implement profit split allocations

So far as the discussion goes, Ernst & Young agrees with the points made in this Issues note. However, the discussion appears to assume that:

- There is no requirement to evaluate the relative importance of diverse non-routine contributions.
- Adequate objective measures of contribution are indeed available.

Based on Ernst & Young's experience, the competitive advantage of groups normally has to be attributed to multiple factors. As each of these factors can, in turn, often be attributed to contributions from more than one entity, it is unavoidable that these issues be addressed in a complete analysis.

It is uncontroversial that objective data (preferably external) should be used if possible. The difficult questions arise when these data have been exhausted. For example, there may be analysts' reports which comment on a group's competitive advantages, but they are unlikely to quantify them. This must be done in a profit split analysis.

Similarly, it is very often difficult in a complex and high integrated group to quantify contributions. For example, in the classical organizational structure of a consumer products group, there will be marketing activities at the global, regional and country level. A framework is needed to determine whether all of these sets of activities are routine and adequately captured by available benchmarks; and a determination must be made on how to allocate that proportion of profit which results from marketing between the relevant entities.

As noted above, Ernst & Young has developed and applied in a number of cases a structured contribution analysis which addresses these challenges. This uses objective data to the extent possible, but it also relies on a management consensus on the relative importance of different profit drivers and entity contributions.

It is our experience that tax authorities are not agreed on the acceptability of this approach. Some apparently exclude the possibility of "subjective" allocation keys when there is no objective key which would meet the criteria set out in this Issues note.

In some cases Ernst & Young has sought to apply features of the global trading model outside the financial services sector and used relative remuneration of employees in high value functions as an allocation key. This possibility is alluded to in Issues note 7 (Para 215) and could helpfully be developed.

The above is no more than an outline of the issue.

It would be helpful for the Working Party to collate and comment on experience of dealing with the complex issues that arise in practice in applying to the transactional profit split

[Section title]

method to integrated businesses with multiple non-routine profit drivers and entity contributions.

## 11. Other methods

In this Issues note, WP 6 reports its conclusions that:

- Methods other than those described in the Guidelines can be used provided that they are the most appropriate in the facts and circumstances and are compatible with the arm's length principle.
- Current guidance on global formulary apportionment is not in need of change.

Ernst & Young agrees with these conclusions.

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SCORE No. DL0030

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