

An/To: OECD - Centre for Tax Policy and Administration

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Betreff/Subject: The Issue Notes on transactional profit methods which have been drafted by the Working Party No. 6 of the OECD Committee on Fiscal Affairs

First of all we would like to convey our compliments to the OECD for the preparation of the series of Issue Notes on transactional profit methods. With great interest we have studied the Issue Notes, which provide an excellent overview of the thinking regarding transactional profit methods.

We set out below our comments which take into account the views expressed by several PwC representatives in Europe, the Americas, India, Australia and Japan.

General observations

Before we address the questions raised in specific Notes, we would like to draw attention to a number of general observations which seem to us to be important.

1. The draft Issue Notes introduce the phrase "transactional profit split". A clarification of the "transactional" aspect of the profit split would be highly welcomed.
 - In Issue Note 1, B, Proposed amendments to the TP Guidelines, the suggested wording for 3.2b includes: "..... in cases where the presence of significant non-benchmarkable contributions (e.g. intangibles) by each of the parties to the controlled transaction or the engagement in highly integrated activities makes a **transactional profit split method** more appropriate than a one-sided method; ..."
 - In Issue Note 2, 37 on page 21 it is reflected " (a) Use of a **transactional profit split** to test the outcome of a transactional net margin method"
 - As from Issue Note 4, the phrase **transactional profit split** is consequently used.
 - The Issue Notes suggest in paragraph 179 that ".. the **transactional profit split** method identifies the profit to be split for the associated enterprises from the controlled transactions.... Accordingly the combined profit to be split should only be that arising from the transaction(s) under review."

The OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations ("the TP Guidelines") discuss "transactional profit methods" and include "profit split" within this. There has so far not been a transactional focus in the circumstances where a profit split is actually applied. In practice it might be said that the reverse is true – that profit split is most usually considered appropriate where the businesses of two enterprises are so closely linked that defining and then benchmarking transactions between them is impractical or impossible. The tenor of much of the treatment of profit split in the Issues Notes is similar - that profit split is also appropriate where benchmarking transactions between two enterprises is impractical or impossible eg due to the "unique" nature of the contributions.

It may be that the OECD's intention is simply to ensure that the definition of the business to which the profit split applies is appropriately defined eg to specific lines of business or parts of a business rather than automatically to enterprises as a whole. If so we would agree and it would be very useful to include some language to this effect.

2. The application of Profit Split is rare in practice for good practical and theoretical reasons. With more focus on proper comparability and the data issues rightly identified in the Issues Notes, there is a risk that profit split becomes a default – that all the other methods are rejected simply because it is possible to challenge the data. Profit split (for which the split itself often does not rely on comparables) then becomes the only method remaining. This would represent a fundamental change to the historic position of the OECD.

There is little distinction between the “transactional profit methods” when discussing their use as secondary methods or when discussing the old distinction between the traditional methods and the profit based ones. However, the circumstances in which profit split is likely to be an appropriate method or secondary method or sanity check are quite limited. For the reasons given below, profit split is often one of the most difficult methods to apply.

Although all transfer pricing is about transactions, we see several obstacles with the focus the draft Issue Notes seem to give to the transactional profit split, including:

- i) the fact that profit split methods typically require inherently subjective judgements about factors and weightings;
- ii) the split of profit is rarely if ever reliant on comparables other than in the broadest possible sense;
- iii) the use of profit split methods as suggested requires that (non-)benchmarkable functions and unique contributions are taken into account, which appears to be a big change to make and would require further discussions to develop a uniform view to the definition thereof;
- iv) a profit split may not be appropriate to provide a basis for compensating high value services where there may be intangibles embedded;
- v) profit split methods can require extensive data from multiple countries which may not be readily available, if available may not be accessible, if accessible may not be required under local law and in all cases may not in fact be necessary when one of the other methods is practical and reasonable; and

For all these reasons, profit split is often a particularly time consuming and expensive method to apply. This means its practical application as a secondary method or sanity check is limited.

On this point we note that an increasing number of tax authorities are routinely requesting financial data of the overseas related party to be provided, in order that they may conduct a profit split analysis regardless of the primary method adopted. Unless it is the intention of the OECD to encourage this approach, we recommend that the limitations on the usefulness of the profit split method and the circumstances in which it is appropriate be more clearly recognised.

We note that one example frequently cited for the use of profit split as a secondary method is to support the use of the comparable uncontrolled price method for licensing transactions. In this case the proper application of the data is not to the combined profits

of both licensor and licensee but to the profits of the licensee alone – there is ample evidence of this in the market. In which case this is not the two-sided profit split method described in the OECD Guidelines. Given the general approach recommended in the Issue Notes, with which we agree, it would also be useful if it were made clear that when used in this way profit split does not need to be two way or applied to the combined profits of two businesses.

3. The Issue Notes introduce a new use of the term "**most appropriate method**" which risks creating confusion even though it appears as if there is no intention to introduce a best method rule..

Paragraph 5 in Issue Note 1 includes the phrase "The selection of a transfer pricing method always aims at finding the most appropriate method for a particular case" and continues by saying "[selection] should take account of the respective strengths and weaknesses of each of the OECD recognised methods...".

Although the discussion draft says in paragraph 8 "... does not mean that all the transfer pricing methods should be analysed or tested in each case" and reference is made to the search process that is proposed in the comparability paper, the approach suggested by the Working Party No. 6 looks quite similar to the "best method" rule which is applied for example in the USA.

PwC recommends avoiding that the phrase "most appropriate method" is used in this way as it does imply detailed consideration of each method before being able to reach a conclusion and suggests that the use by a taxpayer of a perfectly reasonable method is subject to review with hindsight of whether some other method would have been somehow "more" appropriate. We note in this respect that the profit based methods are often more suited to use *ex post facto* when profit is known.

We would have summarised the position of the Guidelines as being that the taxpayer must select "an appropriate method given the circumstances" and we think that this should remain the criterion that is used.

4. Benchmarkable functions and unique contributions. We urge the OECD to address the comments to the comparability calls for interest, in particular as to the likelihood that a strict adherence to the five standards of comparability can realistically be achieved. In that way, the concept of "non-benchmarkable" might give less room for interpretation and potential controversy.

The Issue Notes provide a number of definitions. Benchmarkable functions, assets and risks are functions, assets and risks for which reasonably reliable comparables exist. The term 'unique contributions' is used to designate non-benchmarkable functions, assets or risks for which no sufficiently reliable comparable data are available. The proposed new paragraph 3.2b refers to "reasonably reliable satisfactory" comparables.

We believe that the use of these terms is intended to be practical and, if so, in general these stipulations are useful. However, there is a risk that as they stand they will adversely affect transfer pricing analysis in two general circumstances: (a) where comparables exist (or are available) but are prohibitively expensive given the size of the tax at stake and other data can be used that are imperfect but provide a reasonable result; and (b) where comparables are

less than perfect and there is scope for dispute over the meaning of “reasonably reliable” and “sufficiently reliable” or even “satisfactory”.

At the very least it would be helpful to use the same qualifier – we would recommend “reasonably reliable” throughout – and to make it clear that “reasonable” has a practical as well as a theoretical relevance ie that it takes into account the facts and circumstances of the case such as the relative size of the transactions (and the tax at stake) the cost of the comparability analysis required and the likelihood of material differences (or improvements) given that the Guidelines are clear that comparability is about ranges and that transfer pricing is not an exact science.

Responses to the specific questions

- **Issue Note 2. Use of more than one Method**

Comments are invited on the instances described under Section A where a transactional profit method may be used in conjunction with a traditional transaction method.

The key issue in the selection and application of any method(s) is that of comparability. It is important to first address this before further steps can be taken. With that, we refer to our previous response on comparability where we urge the OECD to give examples on how to properly apply the five standards of comparability given the deficiencies in finding publicly available financial information on a transactional basis.

"There is no doubt that the absence of reliable external data is often a key problem in conducting comparability analyses. Based on the quality and level of detail of the available information, despite reasonable efforts by taxpayers, it is often difficult or even impossible to apply all five comparability factors. In these circumstances the application of the five comparability factors may need to be limited on a case-by-case basis for practical reasons. The selection of the factors to be taken into account will be influenced by the data availability. In practice data on the first two factors (Characteristics of property and services, Functional Analysis) tend to be more accessible, at least in general terms, even when using commercial databases. In view of data availability issues tax administrations should recognise that all five factors cannot always be used and therefore an analysis based on all five factors should not be prescribed. Furthermore, the search for data on all comparability factors should not impose disproportionate administrative burden and costs for taxpayers. One relevant principle not mentioned in the Issue Notes is that the extent of the work required should depend on the magnitude of the issue."

In practice, the TNMM is already commonly used in conjunction with a traditional transactional method, in particular when the resale price method is applied as the gross margin should leave an acceptable net margin. The TNMM is a good solution where operating expenses represent additional functions but it is not clear how these additional functions are accounted for at the gross margin level, since TNMM includes this in its result. Occasionally, the ranges derived from a gross margin analysis for the Resale Price method are fairly broad, therefore, the TNMM may be used in conjunction with the resale price in this respect, or where medium to long term losses are forecast.

An instance where profit based methods can also be very useful applied in conjunction with a traditional transaction method is the CUP method when applied to Intellectual Property. There

are circumstances where extreme outcomes change prices e.g. in distribution or long term supply arrangements where the principal does not want the counter-parties it relies on to go out of business or lose their interest in performing well. Such circumstances assist in identifying an appropriate position in the range (e.g. above or below the median) especially when this can be confirmed from the functional or industry analysis.

One thing which we observe in practice which is not reflected in the Issue Notes is that where there are difficulties with the ranges that result from the data available (eg if the resulting range is relatively broad) a reasonably reliable result can often be obtained by considering the facts and circumstances and concluding on whether there are factors that would point to a position in the range such as above the median, at or near the median or below it. This is a practical way of resolving comparability issues that often works well.

One of those factors may be TNMM – for example where a relatively broad gross margin range for the resale price method is tested against an operating margin (return on sales) range to determine whether a gross margin in, say, the lower or higher half of the full range is appropriate.

It should be noted nonetheless, that it may be difficult to apply practically a transactional profit method in conjunction with a traditional transaction method when a company has numerous products or services particularly if they come from or go to different related parties ie where the transactions are with multiple parties.

As outlined in paragraphs 26 and 27:

- (a) The primary method raises a concern about comparability, e.g., CUP data that is becoming dated or that is not comparable in limited respects. On this point we note that the first bullet of the proposed section 1.69a and the third bullet of the proposed section 1.69c (para 42, p23 Discussion Draft) overlap in some respects. We also note that care should be taken when using a transactional profit method to confirm a primary method which has comparability concerns - if the lack of comparability under the primary method is too great, it may raise a question whether that particular method is the most suitable method after all. (This is consistent with the OECD comments at para 31, p20; and the proposed wording for section 1.69g; para 42, p24).
- (b) Where the jurisdictions on the two sides of the relevant transaction have different rules as to applicable methods (or their hierarchy), two methods providing similar results may be useful.

- **Issue Note 2. Use of more than one Method**

Comments are invited on the 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.

With regard to the Profit Split Method, the absence of perfect comparables for the other methods should not be the reason for its application. Much here depends on the terms “reasonable”, “reliable”, “sufficient” and “satisfactory” which are discussed above. Due regard should be given to parameters applicable for the selection of Profit Split Method such as integrated or interrelated transactions or unique intangibles. We recommend that the necessary clarifications are inserted in the commentary to clearly bring about the distinction between the applicability of the transactional profit method as complementary to or in conjunction with a

traditional method and a sanity check to test the correctness of the result of a traditional method. Guidance is also recommended on the sensitivity of applying a sanity check without further analysing the business circumstances leading to probable losses.

There are concerns that the Issue Note would encourage the use of a secondary method as a sanity check in every case, and that the same intensity of analysis as for the primary method is expected. Although the tax authorities should logically not expect a secondary method or a sanity check to be applied to the same standard as the primary method this is not made clear in the Issue Notes.

If the use of a sanity check would be insisted upon by the tax authorities in every case, it would result in onerous document compilation on the part of the taxpayer. The application of a sanity check should not require a tax-payer to prepare data that it does not routinely keep. Definite guidelines and circumstances for the use of a sanity check and strong emphasis that a sanity check may not be required in every case would be useful.

Any method can be a sanity check, including other applications of the same method. Indeed, sanity checks may exist that have little to do with the recognised methods themselves and it would be useful to note that the use of such an approach should not be ignored simply because it is not one of the recognised methods. The issue remains as to how to comparatively evaluate the reliability of different methods against the same comparability standard when they are impacted by the comparability factors in different ways.

In general however, and for the reasons set out above, it will almost always be TNMM that is the most appropriate check. It is important to note that for sanity checks to be useful, they also need to be relatively easy and straightforward to perform. Consequently, profit split has disadvantages that in most cases will make it inappropriate as a "sanity check" – notably that it often requires a lot of information from different countries which may not be readily available to the business, extensive analysis of that information, and usually subjective judgements on factors and weightings. A comparison of a taxpayer's actual profits with overall profitability for the purposes of a sanity check does not necessarily require a full profit split analysis as described in the Guidelines (and later on in the discussion draft).

The question of whether profit split as a sanity check can work arises as well when the supply chain is in a loss position and at the same time examining a distributor using RSM or TNMM. The arm's length principle can result in the "creation of income" (e.g. where the combined business makes a loss but the distributor should make a profit). While it is correct to say that the profitability of the group as a whole should not be relevant, given the difficulties associated with profit split, it is not generally suitable as a secondary method or as a sanity check.

PwC therefore agrees with the OECD Discussion Draft that a taxpayer should not be required to conduct an analysis of transfer pricing using more than one method. Further, we generally agree that there may be circumstances in which – upon the taxpayer's fair assessment - it may be considered helpful to use transactional profit methods in conjunction with a traditional transaction method as a sanity check. In principle, if both methods are equally good, then they should give similar results. However, it has to be borne in mind that the results will not be identical because prices are never exact and, by definition, a sanity check rarely has the same effort made to make it wholly reliable. The OECD has already adequately addressed this aspect by the introduction of the arm's length range concept.

Additional issues arise when one method has been selected as a primary method (eg a TNMM), and another method was applied as a sanity check (eg an RSM), but with better judgement the sanity check should have been used as the primary method. In other words, there is a debate about which method is the true primary method.

What remains to be answered is what the consequence is when the sanity check delivers a materially different result? If the primary method is reliable and a secondary method delivers another result, it would not automatically make the first result less reliable. As such, we agree to the comments reflected in paragraph 32.

If the method applied provides a result that defies common (business) sense, it may be an indication that something is missing from the analysis i.e. the method may be inappropriate; the data used to apply it may be poor, incomplete or inappropriate; or the method may have been incorrectly applied e.g. cost plus using incomplete cost data. Before recommending the use of secondary methods, it would be useful to stress the need to apply the primary method carefully and appropriately and have confidence that the method chosen is indeed the primary method.

There is a risk in suggesting the use of more than one method that the process becomes more mechanical and less properly analytical particularly if it leads to more frequent use of the profit based methods. The danger with examples is that there is then a temptation to apply them as if they were rules. There could be a high risk that taxpayers and tax authorities would try to use them in this way. That said, it would nonetheless be useful to identify situations where experience has shown the use of single methods alone to be vulnerable.

- **Issue Note 2. Use of more than one Method**

Comments are invited to the tentative draft of Chapter I, section C (x) of the TP Guidelines.

Technically, the arm's length principle as set out in the Guidelines does not require more than one method provided that the method gives a reliable result in the circumstances. This means both that the method is appropriate and that there is data to apply it reasonably.

The taxpayer should have the choice of applying a one-sided versus two-sided approach, depending on the case. We note that as described above, depending on the definition of the profit to be split, a split does not have to be two-sided although the Guidelines (and the current Discussion Draft) define profit split in this way.

PwC agrees that there may be cases where a secondary method is valid as a "sanity check" on the primary method, including in those circumstances identified by the OECD (see section 1.69c, p23). However, as reflected above, we would urge the OECD to make it clear that performing a sanity check using a secondary method should not be considered a requirement of standard transfer pricing analysis but an exceptional step under influence of particular circumstances.

- **Issue Note 7. Application of a transactional profit split method: determining the combined profit to be split.**

Countries have contrasting experiences with the use of gross profit splits in global trading operations and countries have expressed scepticism in this respect. Com-

ments from the business community are invited on whether the example at paragraph 3.17 of the TP Guidelines is still regarded as a valid one.

The example is generally regarded as still being valid. It is consistent with cost (in)efficiencies being allocated to the more (in)efficient parties. The gross profit split can also be based on consolidated contributions on the group gross margin, however these contributions should be homogeneously calculated (i.e. there should be no discrepancy caused by local GAAP).

Some responses to the respective Issue Notes

Issue Note 3 - Access to information

Although Issue Note 3 reflects that the access to information will be addressed when the OECD revises Chapter V of the TP Guidelines, we see a particular risk that the workload on taxpayers is increased unnecessarily if tax authorities are invited to demand increasing levels of information which may not be readily available. PwC agrees with the OECD Discussion draft that a taxpayer should not be required to provide financial and other information of overseas related parties where the domestic entity is the tested party in a one-sided method (para 52(iii), p27). One of the principles in the TP guidelines is the focus on what independent parties would do. When one such party contracts with another it generally has a reasonable understanding of the role and responsibilities of the other that does not require detailed or confidential information. With that in mind, tax authorities should only require information which an independent third party would be expected to have when using the same method and, under those conditions, focus on qualitative data rather than quantitative data.

Issue Note 4 - Unique contributions

It would be helpful to say that if the taxpayer has made reasonable efforts taking into account the provisions of paragraph 5.6 of the Guidelines (not having to search for data at disproportionate cost), then it may validly treat the activities in question as non-benchmarkable.

Non-benchmarkable functions, assets and risks are then equated in Part 4 to “unique contributions”. But unique means something specific – there may be non-unique activities for which there are simply no direct comparables (for a reasonable cost). This becomes particularly relevant when reference is made to “unique intangibles”. Intangibles are particularly difficult to benchmark (Chapter VI of the Guidelines). It is likely therefore that a lot of intangibles will be held to be “unique” if a tax authority insists on a high level of comparability and push the analysis towards profit split despite the fact that they may not be particularly high value and may be routine in the business.

We agree that if the unique intangibles are not “highly valuable” they may not “materially affect the conditions of the transaction” and therefore not affect the choice of method (Paras 62 and 64). Also, one party may be entitled to profits that are at the top of or above a range provided by a TNMM due to their unique market or commercial circumstances. None of these situations ordinarily require a profit split approach.

PwC believes that intangible transactions should not be treated differently from other transactions, simply because they are intangible transactions (paras 84 to 89, p33-34). Thus, the discussion and conclusions from Chapter 2, "Use of More than One Method", should also apply to intangible transactions.

To test the soundness of the outcome of a profit split method, some sort of (potentially subjective) contribution analysis should be performed to reflect the relative value of the contributions by the parties. One of the advantages of profit split is that it is the relative contributions that matter not their absolute values. We feel that paragraph 70 of Issue Note 4 could be more elaborate on this point – at present it merely notes that these have been reported.

Issue Note 5 - Standard of comparability

Illustration 2 in Issue Note 5 implies that a return is earned over and above the cost of any risk. This is a view taken by many tax auditors but is only correct over the (very) long term. Risk is something that may lead to a cost – if the cost is inevitable then it is an expense and not a risk. In the short term (say 1-3 years) the premium earned for carrying risk may not exceed the costs arising from those risks. Correspondingly, the risks may carry low or no costs for some years. Consequently it is very difficult to benchmark individual risks and unless the transaction is a form of insurance or guarantee, it is rarely necessary to do so particularly if the risk in question is a normal risk of the business in question. Whilst we recognise that the illustration is there to make a point, it would be important for the accompanying text to note the true nature of risk.

PwC would welcome the "reasonable cost" principle to apply to any and all comparability analysis.

Issue Note 6 - Profit margin indicators

PwC agrees that it is preferable not to have a prescriptive list of profit level indicators under the transactional net margin method, nor a prescriptive list of situations where particular profit margin indicators should be applied.

However, we note that there are instances where tax authorities have restricted the profit level indicators available under the transactional net margin method to those indicators based on sales or costs. Application of the transactional net margin method to profit level indicators that are based on other measures, such as assets or capital, are less widely accepted. This may be based on an argument similar to that described by the OECD, in relation to adopting a denominator that can be reliably measured and compared (paras 148 and 149, p49).

However, in at least one situation - that of global trading - the measurement of capital and the return thereon may be the only means of determining the return attributable to the risks undertaken by the entity that acts as the booking location. Capital intensive operations (often manufacturing) often call for an asset or capital based PLI and the transfer pricing analysis on any other basis may sometimes be non-sensical. Thus, we recommend that the OECD provide some separate guidance in relation to capital as the denominator in addition to the footnote on page 53.

We recognise the difficulties of using book value rather than market value but where circumstances warrant it practical solutions can often be found – perhaps by adjusting for depreciation. It is also the case that capital is not always or only represented by land, buildings, plant or machinery. Significant amounts of capital may be financial or otherwise marked to market. It would be helpful if this were recognised in the text which seems to imply that book value is the only alternative to market value and because book value is flawed and market value for the comparable companies unknowable the whole subject of ROA or ROCE is to be discarded. For the reasons given in the preceding paragraph such a conclusion appears to be rather extreme.

Whilst the limitation to the use of the Berry ratio as stated in Issue Note 6 reflects the original use of the ratio and Professor Berry's own views, the Berry ratio is more useful than the text would suggest. For example, when examining an agent (where the reported income is in fact commission, i.e. the equivalent to gross margin) or a distribution company if, like an agent, it carries little or no risk (i.e. where it is equivalent to a marketing service provider for the manufacturing entities in the group). When examining third party comparable companies which seem to act both as agent and distributor, the Berry Ratio may be the only consistent way to make a comparison. It should be noted that the results of Berry ratio analysis on distributors consistently provide evidence of higher mark ups on operating cost than the equivalent cost plus analysis on marketing service providers – thus confirming the proposition set out in the current Discussion Draft that there is a return for actual selling. We feel that the valid uses of the Berry Ratio are not quite as limited as the current draft suggests.

We also note that the Berry ratios for the two Cases of Illustration 1 are virtually identical (1.14 and 1.15). In Illustration 2 the two ratios are identical. This is, of course, what advocates of the Berry ratio would expect.

In certain circumstances, adjustments may be required to be made to the operating profit margin of comparable companies in order to make their profile more or less similar to the tested party. For instance, the tested party may be a limited risk distributor, not performing significant functions of sales promotion and marketing and accordingly not assuming any risks with respect thereto, whereas comparable companies in public databases would generally have significant expenditure on account of sales promotion and marketing. The return or reward for a limited risk distributor would be much less as compared to that for a marketing distributor, thus a need would arise for adjusting the profit margin of the comparable marketing distributors with the element of profit earned by them for the functions and risks related to such marketing activities. Let us say that from the database, it is possible to correctly identify the expenditures incurred by the comparable marketing distributors on account of sales promotion and marketing. However, it is difficult to identify and adjust the profit element associated with such expenditure. If one assumes that comparable distributors have earned a uniform profit element at the net level over the various types of expenditure, then there would not be any occasion or need to make the adjustment, with the result that the net operating margins of the comparable marketing distributors would not be proper indicators for the margin of the tested party, being a limited risk distributor.

Some observations as to the determination of the net profit (section B). PwC agrees that the net profit of the selected comparable companies should be used taking into account those elements of the profit and loss statement that ensure comparability with the functions and risks of the tested party ('s transactions). We feel however that the largest emphasis should be put on consistency of calculating the net profit margin so to ensure the same elements for determining profitability are taken into account both with the tested party and the comparable companies. There is in our view a twofold risk if too much emphasis is put on identifying particular items such as pension costs, stock options etc in the profit and loss statements of comparable companies. First of all, this may put an unreasonable burden on the taxpayer and secondly, it does create a risks of inaccuracy both because of arbitrary approaches and lack of sufficiently detailed information with the comparable companies.

Issue Note 8 - Reliability of a residual analysis and a contribution analysis

In Issue Note 8 the Working Party suggests amending paragraphs 3.19 to 3.21 of the TP Guidelines.

There are very few cases where no part of the combined business is capable of being benchmarked. The implication of the text is therefore that the residual analysis method will in most cases be more reliable. This is correct but there are two sets of circumstances worth considering in more detail: (a) cases where the overall result is a loss or the residual is a loss where the right treatment (as set out in the Issues Note) seems less clear – so it would be worth spelling the conclusion out more clearly; (b) the (rare) situations where even the benchmarkable functions are shared e.g. global trading cases where the back office functions in one country support the activities of all the participants as a global book moves from location to location – where contribution analysis may therefore be as reliable or potentially more reliable than using the residual method.

It has to be borne in mind that while benchmarkable functions may be present for one party, the other party may have few benchmarkable functions related to the transaction being tested. Guidance here is required as to how integrated transactions need to be before such an approach can be contemplated, especially if both sides of analysis are included on a whole of entity basis. In addition, it should be noted that an emphasis on functions overlooks the point that (other than global trading) in many, if not most cases, (given that the profit split method has been selected), the relevant factors will in fact be assets (such as intangibles) or risks. Particularly in respect to global trading, the example given does not provide a return to the booking location for the risks undertaken in providing capital to support the book, even if that booking location has traders (in which case the profit allocation would be to reward the trading functions rather than acceptance of capital risks).

Issue Note 9 - How to split the combined profit

It is important to note that the profit being split is the combined profit, which implies that there is a single business being conducted by two or more parties or that two businesses are closely interrelated. The evidence in the market is that a licence rarely represents such a relationship between the licensor and licensee – and the evidence in the market is that where they look at profits, they look at the profits of the licensee and not the “combined” profit of the two businesses. An approach that looks at licensee’s profits as a part of the rationale for establishing a royalty is not strictly a profit split as described in the Guidelines and is not done the same way. Indeed, the determination of a fair result (taking into account the functionality and risk profile) that is left over to the licensee can be achieved based on a one-sided approach at the level of the licensee as tested party.

PwC agrees that it is better not to establish a prescriptive list of allocation keys to be used in profit splits (para 221, p67), and that relevance and acceptability of any allocation key or combination thereof should be evaluated based on the facts and circumstances of each case (para 226, p68). However, we note that some tax authorities have indicated a preference for focusing on components of costs and expenses (depending on the facts and circumstances), as the primary method of allocation.

PwC feels that the practical reality is that profit split should remain a method of last resort because it is only when businesses are closely combined or integrated as an economic business, or (usually for the same reason) when no other method is capable of being applied that it is appropriate and, given the inherently subjective nature of the factors and weightings that are usually required, more reliable than other methods. Another observation is that the actual application of the profit split method when it is used in practice is very rarely “transactional”.

The assumption that the profit split would be based on contributions made by the parties is in principle correct, but it is important to note that in a negotiation between independent parties, the following elements are important and should be included in an evaluation of contribution: (a) risk; (b) bargaining power – typically arising from intangibles that do not qualify as assets (i.e. property that can be transferred) and which might not otherwise be recognised such as market position.

It would be helpful for the OECD to clarify that taxpayers seeking to use multiple year data in transfer pricing analysis, need not necessarily demonstrate that prior year data has indeed influenced the transfer prices of the taxpayer in the current year – it should be sufficient to show that information relating to prior years may have or could have potentially influenced the determination of general transfer prices prevailing in the industry, on account of general industry cycles.

Issue Note 10 - Other methods

It would seem that satisfying the threshold of providing “a better solution” relative to measuring arm’s length outcomes would be sufficient to enable use of an “other” method, as opposed to first being required to demonstrate that the OECD recognized methods are “non-appropriate” and “non-workable”; moreover, utilizing the most reliable measure of arm’s length outcomes is the better standard as opposed to merely achieving a “workable solution” utilizing a “recognized” method. The Guidance should instead prevent less reliable methods, while “appropriate” and “workable”, from trumping more reliable methods, and, accordingly, we suggest this change. The threshold for “other methods” as described in the Discussion Draft is higher than that for “unspecified methods” in the US 482 rules (where the method need only be the most reliable measure of an arm’s length result under the principles of the best method rule), and inappropriately so. The adoption of this position by the OECD would produce an inconsistency with US rules, with potential negative consequences for taxpayers, and tax administrations for that matter. Further, this position could lead to situations where taxpayers and tax authorities debate whether an approved method is “appropriate” and “workable”, as opposed to whether the method providing the best, most reliable solution to measuring arm’s length outcomes was applied.