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Transactional Profit Methods

Discussion Draft for Public Comment

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Dear Mr. Owens,

Following the Organization for Economic Co-Operation and Development's ("OECD") invitation to comment on a series of Issues notes on transactional profit methods ("the Issues Notes"), you will find below our comments relating to the Issues Notes.

General Comments

As a general comment, we agree with the OECD's revision of the status of transactional profit methods as last resort methods. In practice, the transactional profit methods, in particular the TNMM, have become primary methods in many instances. As a result, there was a need to revise the OECD's TP Guidelines to ensure that it more accurately reflects the realities of transfer pricing.

Although the Issues Notes discussed many topics related to the application of the transactional profit methods (e.g., standard of comparability, selection and determination of the net profit margin indicator), many issues remain ambiguous. While we appreciate that the OECD's transfer pricing guidelines are not prescriptive by nature, a discussion without an affirmative conclusion may only create more ambiguity with respect to certain issues both for taxpayers and tax administrations.

The following are our comments on specific topics discussed in the Issues Notes.

I. Transactional Net Margin Method – Strengths and Weaknesses

3.31 A one-sided analysis may not take into account the overall profitability of the MNE group from the controlled transactions for purposes of comparability. A one-sided analysis potentially can attribute to one member of an MNE group a level of profit that implicitly leaves other members of the group with implausibly low or high profit levels. While the impact on the profits of the other parties to a transaction is not always a conclusive factor in determining the pricing of a transaction, it may act as a counter-check of the conclusions reached¹.

¹ "Transactional Profit Methods – Discussion Draft for Public Comment" (OECD, 25 January 2008), Para. 3.31, at 15.

This statement is confusing because the application of a one-sided analysis, by definition, does not take into account the overall profitability of the MNE group. A one-sided analysis is applied to the tested party, which is the least complex entity. As such, the purpose of a one-sided analysis is to attribute to the tested party the level of profits that an arm's length party would have earned in comparable circumstances. Any residual profit or loss from the controlled transaction is left with the other party to the transaction which is the more complex entity that assumes most risks. Therefore, one would think that the overall profitability of the MNE is irrelevant for the purposes of a one-sided analysis.

Consider, for example, two MNEs that are doing business in the same industry. First MNE is profitable and the second one is in a loss-making position due to various reasons such as ineffective management or production inefficiencies. Both MNEs ("Parentco") have a subsidiary in a foreign country ("SubCo") that performs sales and distribution functions. Both SubCos perform routine sales and distribution related functions and do not own any valuable intangibles. A one-sided methodology (either Resale Price or TNMM) is determined to be the most appropriate in the given circumstances. A level of profit is attributed to each of the SubCos, based on the level of profits earned by comparable arm's length sales and distribution entities. As a result of applying this methodology, Parentco in the second scenario increases its loss, while Subco earns a routine sales and distribution profit.

Paragraph 3.31 of the OECD Guidelines suggests that for the second MNE "*a one-sided analysis potentially can attribute to one member of an MNE group (the tested party in our case) a level of profit that implicitly leaves other members of the group with implausibly low or high profit levels.*"² We argue that unless SubCo owns valuable intangibles or assumes risks higher than the comparable arm's length sales and distribution entity does, in which case a Profit Split method may be more appropriate, the overall profit or loss of an MNE group should not matter for the purposes of a one-sided methodology. In other words, the entity that performs more complex functions and assumes more risks is the one that should bear the risk of losses or reap the benefits of excess profits.

If the objective of considering the profitability of the other members is to validate use of the one-sided methodology, we believe that this can be better achieved by analyzing other indicators of the tested party financial information, such as SG&A intensity for a sales and distribution entity or capital intensity in the case of a manufacturer.

In the above example, if Subco's SG&A level is very high, the use of the TNMM in setting the transfer price could cause Parentco's profit to be artificially low since it is in essence subsidizing Subco's SG&A. However, this should be borne out by comparing Subco's SG&A intensity to the comparables, the result being, that if the tested party's SG&A intensity is inconsistent with the comparables, then a further analysis may be required. For instance:

- i) The higher SG&A intensity may be an indication that Subco in fact undertakes more than a "routine" sales and distribution entity and therefore, a one-sided methodology may not be appropriate in the circumstances;
- ii) The difference in SG&A intensity may require an adjustment to be made to the comparables' profit levels;
- iii) Alternatively, the higher SG&A intensity may be indicative of the tested party being in a start-up phase and a determination must be made as to which party is responsible for start up costs/losses.

² *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (Paris: OECD, 1995) (OECD Guidelines), Para. 3.31.

In our view, the overall profitability of an MNE group is only relevant for the purposes of a two-sided methodology such as a Profit Split. Where a one-sided methodology is used and the tested party performs functions and assumes risks similar to those of the comparable arm's length entities, the overall profitability of an MNE group should be irrelevant.

II. Use of Transactional Profit Method in Conjunction with a Traditional Transaction Method

You have asked for comments from the business community on the instances described under Section A where a transactional profit method may be used in conjunction with a traditional transaction method.

Our example involves a situation in which an intangible property is being licensed between two related entities. The determination of the appropriate arm's length return for an intangible property is never a simple task because the intangible property is unique by nature, thus making a comparability analysis very difficult.

Generally, the first step of the benchmarking analysis involves an examination of the terms and conditions of the license agreement, the intangible property itself and the rights of the parties to the transaction ("licensor" and "licensee"). The second step is the method selection. The Comparable Uncontrolled Price ("CUP") method was selected as the primary method in this example.

A CUP can be found in either internal or external transactions. An internal CUP may be found where the licensor or licensee enter into similar licensing arrangements with a third party. However, the cases where an internal CUP can be found are infrequent. Hence, in most cases a search for an external CUP is performed.

An external CUP may be found where similar licensing arrangements are entered into between third parties completely external to the licensor and the licensee. We conducted a search for license agreements between unrelated parties that involved intangible properties that were broadly comparable to the tested one (e.g. the intangible property included trademarks and brand names in a defined industry). However, there are significant shortcomings with this type of search;

- i) as previously mentioned, intangible property by definition is unique and therefore comparability of the intangible property will be weak at best;
- ii) there is limited data that is publicly available to properly analyze the terms and conditions of the external licensing arrangements.

These shortcomings limit the reliance that can be placed on such a search and therefore we could not rely solely on the results of this search to support the royalty rate to be used in the tested transaction.

As a result of these deficiencies in the CUP analysis, we used the TNMM to test the licensee's operating profit (after payment of the royalty) as an indirect measure of the reasonableness of the royalty rate as an arm's length rate.

In this situation, even though a preferred method such as the CUP is used, the lack of available data severely limits the reliability of the results as a stand-alone methodology. Therefore, this is a situation where the primary methodology in conjunction with the TNMM can produce a more reliable result.

III. Cases Where the Net Profit is Weighted to Costs: What Costs Should be Included in the Denominator

Actual costs, standard costs, budgeted costs

The Issues Notes discuss the question of whether actual costs, standard costs or budgeted costs should be used in the application of the transfer pricing method.

In theory, if we are to abide by the principle that transfer prices should be set “contemporaneously”, then the answer should be that transfer prices should be established on standard or budgeted costs. Moreover, under the arm’s length principle, once these prices have been established, it is not usual for parties dealing at arm’s length to then adjust the prices based on actual costs incurred and therefore, transfer prices should not be established based on actual costs.

This conclusion is appropriate if the variance from budget to actual is within a certain “normal” range. However, if the variance is significant, then a deeper analysis is required to determine the cause of the variance and whether such variance would be transferred to the other party to the transaction under arm’s length circumstances. For example:

- i) Suppliers that rely heavily on oil prices may go back to their customers to adjust their prices given the huge and unexpected increase in the cost of oil;
- ii) A company consistently over budgets their expenses (for other non-tax motivated reasons) and as a result has a net operating profit that is much higher than third party comparables. If the company has a history of over budgeting then basing the transfer price on budgets is clearly not appropriate since the budgeted costs do not reflect a realistic expectation of costs. In this case, year-end adjustments may be required to ensure a reasonable arm’s length profit is achieved.
- iii) Actual manufacturing cost is much higher than standard cost due to unforeseen cost overruns, for example a higher than normal employee turnover, or a breakdown of machinery. These are normal risks that a manufacturer assumes and would not justifiably be charged over to the customer and therefore, a transfer pricing adjustment based on actual costs is not warranted.

While the above comments may be theoretically sound, in practice a larger consideration in the administration of transfer prices is risk management. If transfer prices are based on budgeted or standard costs, there is the risk that the tax administration proposes an adjustment, without due regard to the causes of the variance, as discussed above. Often, the inconvenience and risks associated with explaining the result and debating the merits of a theoretically correct application of the transfer price is simply not worthwhile. Therefore, as a matter of convenience and risk minimization, taxpayers often automatically adjust their transfer prices to actual costs to avoid any such challenge by the tax authority.

Final Remarks

Thank you for providing us the opportunity to express our views. We appreciate the work that is done by the OECD to improve the existing global transfer pricing regime and we are looking forward to seeing the new Guidelines that will express current needs of transfer pricing practitioners.

Yours truly,

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