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Ref Comments on OECD Issues Notes on  
Transactional Profit Methods

### **OECD Invitation to Comment on Issues Notes on Transactional Profit Methods**

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The OECD has requested comments on a series of Issues notes that was drafted by the Working Party No. 6 of the OECD Committee on Fiscal Affairs ("the Working Party") on the Transactional Profit Methods. The Issues notes, which were released on January 25, 2008, seek to build on the experience acquired by countries in applying transactional profit methods since the adoption of the Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations ("the TP Guidelines") in 1995 and on comments received from the business community in response to an earlier open invitation to comment on issues in relation to profit methods that was released in February 2006. This submission provides KPMG's Global Transfer Pricing Services (KPMG) comments on the Issues notes drafted by the Working Party. The Working Party's draft on the Transactional Profit Methods consist of ten Issues notes ("2008 Discussion Draft") and the comments provided below have been grouped by the specific Issue note to which they pertain.

#### **Issue Note 1 - Review of Transactional Profit Methods: Status as Last Resort Methods**

This Issue note focuses on the question of whether to maintain the last resort status accorded to the transactional profit methods under the 1995 TP Guidelines where the use of these methods is limited to those exceptional situations where there are no data available or where the available data are not of sufficient quality to rely solely or at all on the traditional transaction methods (see paragraphs 2.49, 3.49 and 3.54 of the TP Guidelines). The tentative conclusions reached by the Working Party is to remove the exceptionality and recommend that the selection of a transfer pricing method always should aim at finding the most appropriate method for a particular case. According to the Working Party, this would put "a greater emphasis on the relative strengths and weaknesses of each method and on the importance of the comparability analysis . . ." (see pg. 6 of the 2008 Discussion Draft). The Issue note then sets forth draft amendments to the TP Guidelines that affect paragraph 1.68 in Chapter I, paragraph 2.49 in Chapter II, and a number of paragraphs in Chapter III.

KPMG is in agreement with the draft amendments to the TP Guidelines that remove the last resort status accorded to the transactional profit methods and with the recommendation that the selection of a transfer pricing method should always aim at finding the most appropriate method for a particular case as set forth in the draft amendments to paragraphs 1.68 and 1.68a. To ensure that the TP Guidelines consistently reflect the removal of the exceptionality and the last resort status accorded to the transactional profit methods, KPMG suggests deleting existing paragraph 3.57 in its entirety. Paragraph 3.57 reminds a tax administration asserting the application of a transactional profit method to be “particularly conscious of its burden in demonstrating to the tax administration of the other State in any mutual agreement” that such an approach is being appropriately applied and achieves the best approximation of arm’s length pricing. Because transactional profit methods are no longer accorded the last resort status, it is no longer appropriate to associate their application with any special burden that needs to be borne by either the tax administration or the taxpayer seeking to apply these methods. KPMG also suggests additional modifications (which are underlined in the text below) to amended paragraphs 3.53 and 3.56 to consistently reflect the removal of the last resort status to the transactional profit methods:

- 3.53 As discussed in this Report, there are substantial concerns regarding the use of the transactional net margin method, in particular that it is sometimes applied without adequately taking into account the relevant differences between the controlled and uncontrolled transactions being compared. Many countries are concerned that the safeguards established for the traditional transaction methods may be overlooked in applying the transactional net margin method. Thus, where differences in the characteristics of the transactions being compared have a material effect on the net margins being used, it would not be appropriate to apply the transactional net margin method without making adjustments for such differences. See paragraphs 3.34-3.40 (the comparability standard to be applied to the transactional net margin method).
- 3.56 In all cases, considerable caution must be used to determine whether a transactional profit method as applied to a particular aspect of a case can produce an arm’s length answer, either in conjunction with a traditional transaction method or on its own (see paragraph 3.50). The question ultimately can be resolved only on a case-by-case basis taking into account the strengths and weaknesses set forth above for a particular transactional profit method to be applied, the comparability (including functional) analysis of the parties to the transaction, and the availability and reliability of comparable data. In addition, these conclusions assume that countries will have a certain degree of sophistication in their underlying tax systems before applying these methods.

The Working Party also tentatively concluded upon the removal of the exceptionality “does not mean in practice that the general preference for traditional transaction methods over transactional profit methods is simply abolished as the Working Party considers that traditional transaction

methods have intrinsic strengths . . .” (see pg. 6 of the 2008 Discussion Draft). These tentative conclusions are reflected in amended paragraph 3.49 of Chapter III which states that “where, taking account of the comparability analysis of the controlled transaction under review and of the availability of information, a traditional transaction method and a transactional profit method can be applied in an equally reliable manner, the traditional transaction method is preferable to the transactional profit method.” Amended paragraph 3.49 also extends this principle to the comparable uncontrolled price method (“CUP”) by stating that if a CUP and another transfer pricing method can be applied in an equally reliable manner, the CUP method is to be preferred.

KPMG is of the view that this conclusion and the amended paragraph 3.49 may not recognize a number of situations where transactional profit methods can be simpler to apply and can be just as accurate as the use of traditional transaction methods. Under these circumstances, KPMG takes the view that the use of transactional profit methods could be appropriate since an application of a transactional profit method could yield reliable results with a reasonable level of effort on the part of the taxpayer. The continued preference towards the use of a traditional transaction method under these situations may create a significant burden for taxpayers potentially similar to that contemplated in the existing paragraph 1.69 of the 2005 TP Guidelines from an undue reliance on the application of more than one method to demonstrate the arm’s length principle. For example, in a multinational group with a decentralized management style, a search by one group member for internal comparable transactions entered into by other companies in the group can often be burdensome. Moreover, the continued preference towards the use of a traditional transaction method when the transactional profit method can be both simpler to apply and just as reliable may result in taxpayers incurring disproportionately high costs and burdens of precisely the kind set forth in paragraph 5.6 of the TP Guidelines. Paragraph 5.6 states that taxpayers should not be expected “to engage in an exhaustive search for comparable data from uncontrolled transactions if the taxpayer reasonably believes, having regard to the principles of this Report, either that no comparable data exists or that the cost of locating the comparable data would be disproportionately high relative to the amounts at issue.” In its earlier response of August 2006 to the OECD Invitation to Comment on Transactional Profit Methods, KPMG had identified several situations where transactional profit methods may be simpler to apply and yield results just as reliable as those obtained from the application of traditional transaction methods. For example, a transactional net margin method (“TNMM”) may be simpler to apply and just as accurate as the use of a traditional transaction method in determining the markup on low value services, the net markup for contract manufacturing, or the operating margin for low risk distributors with no unique intangibles.

Based on the foregoing, KPMG suggests limiting the preference for the use of traditional transaction methods in paragraph 3.49 to situations where both methods can be applied in an equally reliable manner using a reasonable level of effort. That is, the preference towards the use of traditional transaction methods would not extend to situations where the transactional profit method is simpler and less burdensome to apply than a traditional transaction method although both

methods can be applied in an equally reliable manner. KPMG's suggested modifications to the amended paragraph 3.49 contained in the 2008 Discussion Draft are underlined in the text below:

3.49 As noted at paragraphs 1.68 and 1.68a, the selection of a transfer pricing method always aims at finding the most appropriate method for a particular case. One essential element is to take account of the respective strengths and weaknesses of each of the OECD recognized methods where each of these methods are applied using a reasonable level of effort. Traditional transaction methods are the most direct means of establishing whether conditions in the commercial and financial relations between associated enterprises are arm's length. As a result, where, taking account of the comparability analysis of the controlled transaction under review and of the availability of information, and a traditional transaction method and a transactional profit method can be applied using a reasonable level of effort in an equally reliable manner, the traditional transactional method is preferable to the transactional profit method. Moreover, where, taking account of the comparability analysis of the controlled transaction under review and of the availability of information, and the comparable uncontrolled price method (CUP) and another transfer pricing method can be applied using a reasonable level of effort in an equally reliable manner, the CUP method is to be preferred. In cases where based on a reasonable level of effort, transactional profit methods are found to be simpler to apply and can be reasonably concluded to yield equally reliable results as traditional transaction methods, a taxpayer will not be required to apply the traditional transaction method in analyzing the controlled transaction. Tax authorities should respect the taxpayer's selection of the method used to determine the arm's length price as long as it is reasonable.

In addition, in the interests of consistency within the amended TP Guidelines, KPMG suggests the following modification to amended paragraphs 2.49 and 3.2d (the suggested modifications are underlined below):

2.49 As noted at paragraph 1.68 and 1.68a, the selection of a transfer pricing method always aims at finding the most appropriate method for a particular case. One essential element is to take account of the respective strengths and weaknesses of each of the OECD recognized methods. Traditional transaction methods are the most direct means of establishing whether conditions in the commercial and financial relations between associated enterprises are arm's length. As a result, where, taking account of the comparability analysis of the controlled transaction under review and of the availability of information, and a traditional transaction method and a transactional profit method can be applied using a reasonable level of effort in an equally reliable manner, the traditional transaction method is preferable to the transactional profit method. Moreover, where, taking account of the comparability analysis of the controlled transaction under review and of the availability of information, and the comparable uncontrolled price method (CUP) and another transfer pricing method can be

applied using a reasonable level of effort in an equally reliable manner, the CUP method is to be preferred.

- 3.2d However, the transactional profit methods may not be applied automatically simply because there is a difficulty in obtaining data. Rather, a taxpayer must make reasonable efforts to search for the data necessary to apply any of the OECD recognized methods. In determining what constitutes a reasonable level of effort, the taxpayer may weigh the time and effort that would be needed to locate the data against the likelihood of finding the necessary data needed to reliably apply any of the OECD recognized methods. The same factors that led to the conclusion that it was not possible to reliably apply a traditional transaction method must be reconsidered when evaluating the reliability of a transactional profit method. ~~Rather,~~The reliability of a method should be assessed taking into account the principles discussed in this Report, including the extent and the reliability of adjustments to the data used.

With respect to the proposed deletion of the word “averages” and its replacement with the word “data” at paragraph 3.30, KPMG is of the view that some tax authorities may argue that the mention of multiple year data in the OECD Guidelines is simply meant to encourage a comparison of the tested party and the relevant comparables over a period of a number of years but on a year-by-year basis only. That is, tax authorities may view the OECD Guidelines as limiting the use of multiple year data for the comparables and the tested party to only demonstrate whether or not all parties followed a similar business path or curve in determining their comparability rather than permitting the use of any type of averaging as a means of reducing volatility in the profitability attributable to business cycles and other short term economic conditions of the comparable companies as well as the tested party. Averaging the results achieved in the uncontrolled and controlled transaction over a multi year period can reduce the impact of differences in business cycles between the comparable companies and the tested party on the profit level indicator thereby potentially yielding a more reliable test of the arm’s length nature of the price in the controlled transaction. KPMG suggests that existing paragraph 1.50 be amended to add the following to explicitly address the use of multi year averaging (suggested modifications are underlined below):

- 1.50 Multiple year data will also be useful in providing information about the relevant business and product life cycles of the comparables. Differences in business or product life cycles may have a material effect on transfer pricing conditions that needs to be assessed in determining comparability. The data from earlier years may show whether the independent enterprise engaged in a comparable transaction was affected by comparable economic conditions in a comparable manner, or whether different conditions in an earlier year materially affected its price or profit so that it should not be used as a comparable. Alternatively, data averaged over a multi year period may minimize the impact of differences in business cycles and other short term economic conditions between the comparable companies and the tested party on their profitability thereby yielding a more reliable test of the arm’s length nature of the price in the controlled transaction.

With respect to the replacement of the word “enterprises” by the word “transactions” in paragraph 3.53, KPMG would suggest that the OECD reconsider this change since some tax authorities might view this change as further support for an undue emphasis on transactional data even where such data may be unreliable.

**Issue Note 2 – Use of More Than One Method (Use of a Transactional Profit Method in conjunction with a traditional transaction method, or sanity check)**

The Working Party’s preliminary conclusion with respect to the use of more than one method in demonstrating the arm’s length principle is to maintain the existing standard of paragraph 1.69 which states that the arm’s length principle does not require the application of more than one method and acknowledges that an undue reliance on requiring an application of more than one method could create a significant burden for taxpayers. KPMG is in agreement with the Working Party’s preliminary conclusions on this issue.

The Working Party identified situations where a transactional profit method may be used in conjunction with a traditional transaction method as set forth in amended paragraph 1.69a and where a secondary method might be used as a sanity check to test the plausibility of the outcome of the primary method as set forth in amended paragraphs 1.69b through 1.69g.

The amended paragraph 1.69a identifies two situations where a transactional profit method may be used in conjunction with a traditional transaction method: (a) Where there is no single sufficiently reliable comparable but multiple sources of data which are all equally reasonably comparable under a transfer pricing analysis, and (b) Lack of clarity as to which method provides the most reliable results so that consistency in the results obtained from competing methods is an additional factor that may be taken into account in the determination of the arm’s length price. It is KPMG’s experience that both of these types of situations occur relatively infrequently and are usually limited to situations where data on internal transactions between the taxpayer and a third party are the basis for the application of a traditional transaction method. For example, detailed data and information on the contractual arrangements, risks incurred and functions performed by parties in external transactions to permit an application of the CUP with the same reliability as a transactional profit method is generally not available. Given the recent proliferation of country specific documentation requirements, the preparation of required documentation of intercompany transactions already impose significant burdens on taxpayers. Paragraph 5.6 of the 1995 TP Guidelines, as noted previously, states that taxpayers should not incur disproportionately high costs and burdens of the type that might result from engaging in “an exhaustive search for comparable data from uncontrolled transactions if the taxpayer reasonably believes, having regard to the principles of this Report, either that no comparable data exists or that the cost of locating the comparable data would be disproportionately high relative to the amounts at issue.” Under these circumstances, KPMG believes that it is especially important that tax authorities respect the selection of the method made

by taxpayer as long as it is reasonable in applying the provisions of amended paragraph 1.69a to the controlled transaction under evaluation. In its present form, paragraph 1.69a does not reflect the limited circumstances that may occasion its application in evaluating a controlled transaction. KPMG recommends adding an additional bullet to the amended paragraph 1.69a as set forth below (this would be the third bullet in paragraph 1.69a):

- In assessing whether there are multiple sources of data that are all equally reasonably comparable or whether there is sufficient clarity as to the method providing the most reliable results, tax authorities should respect evaluation of these issues as reflected in the taxpayer's selection of the method as long as it is reasonable.

For consistency, KPMG recommends that a similar change be made to the amended paragraphs describing the use of a secondary method as a sanity check. Specifically, the following modification may be made to amended paragraph 1.69f (KPMG's modifications are underlined below):

1.69f Where a secondary method is used as a sanity check to test the outcome of a primary method (whether a traditional transaction method or a transactional profit method), the latter remains the applicable method and the secondary method is only used to identify unusual outcomes that would suggest the need to further review the choice and application of the primary method. A method should not be rejected just because it produces an unusual outcome. Tax authorities should respect the taxpayer's selection of the method used to determine the arm's length price as long as it is reasonable.

Paragraph 1.69c identifies instances where it may be appropriate to use a transactional profit method to test the outcome of a traditional transaction method. One such situation identified in the paragraph is where the use of a traditional method leads to an outcome that appears commercially unrealistic with respect to the controlled transaction. Paragraph 1.69c does not, however, provide any guidance on what would constitute a commercially unrealistic outcome and seems somewhat at odds with paragraph 1.69f which states that a method must not be rejected because it produces an unusual outcome. KPMG would suggest that further guidance be provided on what would constitute a commercially unrealistic outcome and how one would distinguish such an outcome from an outcome that is unusual as referenced in paragraph 1.69f.

### **Issue Note 3 – Access to the Information Needed to Apply or Review the Application of a Transactional Profit Method**

While the Working Party concluded that the issues relating to proper access needed by tax authorities to the information needed to apply or review taxpayer's application of transactional

profit methods will be addressed at a later stage when the OECD revises Ch. V of the TP Guidelines, the Working Party did reach two tentative conclusions:

- (a) Existing paragraph 3.28 of the 1995 TP Guidelines which states that in applying the TNMM “it is not necessary to determine the functions performed and responsibilities assumed by more than one of the associated enterprises” needs to be fixed as it is not accurate. Specifically, the Working Party concluded that while the use of one-sided methods such as the TNMM requires only examining the profit level indicator for one of the parties to the transaction (the “tested party”), information is needed on the five comparability factors and in particular on the functions, assets and risks of all the parties to a controlled transaction irrespective of whether the method is one-sided or two-sided. With respect to the financial data that is needed where the taxpayer is using a one-sided method, the Working Party acknowledged that the tax administration would generally have no reason to ask for financial data of the non-tested party.
- (b) Because transactional net margins necessitate allocation of costs and revenues at the transactional, business line or product line level including allocation of overhead and other expenses, tax administrations typically need information on the choice of the allocation methods in order to assess the reasonableness of the allocations made by taxpayers in evaluating a transactional profit method.

While KPMG is in agreement with each of these tentative conclusions of the Working Party, we recommend that future revisions to Ch. V of the TP Guidelines clarify that tax authorities should limit the information that they request as part of the normal documentation process to those data that are needed to make a reasonable assessment of the taxpayer’s transfer pricing under normal circumstances. For example, if a taxpayer selects the TNMM as the method to determine the arm’s length price, tax authorities should first evaluate the reasonableness of the taxpayer’s selection of the TNMM in light of the information on the functions, assets and risk of all the parties to the controlled transaction and the financial data on the tested party and the comparables. Tax authorities should not routinely request data on the profit level indicators of the non-tested parties without a careful evaluation of the reasonableness of the taxpayer’s selection and application of the OECD recognized method.

#### **Issue Note 4 – Application of Transactional Profit Methods and Unique Contributions**

In this Issue Note, the Working Party identifies the circumstances where it would be appropriate to use the transactional profit split and transactional net margin methods and some issues that arise in applying these methods in determining an arm’s length price.

KPMG is in agreement with the Working Party's conclusions that a transactional profit split method may be found to be the most reliable method when (a) there is insufficiently reliable comparable data to apply traditional transaction methods or a transactional net margin method because both parties in the controlled transaction make unique contributions or because the presence of significant functions, intangibles or risks present in the controlled transaction cannot be ascertained in the comparables, or (b) where valuable contributions are made by both parties to a transaction and at arm's length independent parties might share the profits of the transaction in proportion to their respective contributions such as in a co-development or co-exploitation of the same intangible. The Working Party acknowledges that the lack of significant intangibles does not automatically imply the use of a TNMM as opposed to a profit split as, for example, in situations where the party's unique contributions consist of performing unique functions or bearing unique risks (see paragraph 77, pg. 32, 2008 Discussion Draft). Because existing paragraphs 3.5 and 6.26 of the TP Guidelines do not address this possibility, KPMG recommends that these paragraphs be amended to explicitly allow the use of a profit split method due to unique contributions by both parties that do not necessarily consist of intangibles.

With respect to available approaches to splitting of the combined profit, the Working Party identifies one common approach as involving "a subjective analysis, using text or charts to show the relative contributions made by the parties." (See paragraph 70, pg. 31, 2008 Discussion Draft). While KPMG believes that a subjective analysis has the potential to provide flexibility to both the tax authority and the taxpayer that is needed to facilitate resolution of issues that arise when applying a profit split method, KPMG recommends that the OECD provide more guidance on how subjective approaches can be developed and presented in a way that does not lead to additional controversy. For example, the Working Party may wish to further clarify the nature of the subjective analysis that would provide a reliable basis for splitting the combined profits in the controlled transaction and the manner in which such a subjective analysis may be documented and substantiated by taxpayers. Similarly, KPMG would recommend that the Working Party provide guidance on procedural steps that would facilitate constructive discussions between the tax authority and the taxpayer in developing a subjective analysis of the relative contributions made by the parties to the profit split. In the absence of clearly articulated standards and procedures, the use of such subjective analysis has the potential for increasing controversy between taxpayers and tax authorities.

KPMG is in agreement with the Working Party's conclusions that the TNMM may be applicable where one of the parties makes all the unique contributions whereas the other party does not make any unique contribution or contributes non-unique intangibles that would be expected to be used by the comparables. As noted by the Working Party, the net margin of the licensee – the tested party with less complex operations – at arm's length may be determined by reference to the net margin derived by independent parties comparable to the licensee; however, this is not mentioned in Chapter VI of the TP Guidelines. KPMG therefore recommends that the provisions in Chapter VI

be amended to explicitly permit an application of the TNMM along the aforementioned lines for purposes of determining the arm's length net margin of the licensee under appropriate circumstances.

#### **Issue Note 5 – Application of Transactional Net Margin Method: Standard of Comparability**

In this Issue Note, the Working Party evaluates the extent to which (a) a lower standard of comparability can be applied to the transactional net margin method from the standard applied to a traditional transaction method, and (b) a lower standard for aggregating transactions can be applied in the transactional net margin method than in a traditional transaction method.

KPMG is in agreement with the Working Party's preliminary conclusion reaffirming the importance of a sufficiently reliable comparability analysis when applying any transfer pricing method including a transactional net margin method while acknowledging that the transaction net margin method may be less sensitive to some differences in product characteristics and even certain functions and risks compared to the traditional transaction methods. KPMG would recommend incorporating illustrations 1, 2 and 3 (pgs. 38-40, 2008 Discussion Draft) that illustrate differences in the sensitivity of the net margin and gross margin/markup to certain differences in functions, risks, and economic profile in the amended TP Guidelines.

With respect to illustration 1 which shows the greater sensitivity of the gross margin method relative to the net margin method to differences in the intensity of the marketing functions performed by the tested party and the comparable, it would be helpful to note that the Berry ratio may be even less sensitive to these differences in the intensity of the marketing functions than the net margin method. For example, the Berry ratio for the third party "comparable" operating as in case 1 is 1.14 whereas the Berry ratio for the tested party operating as in case 2 is 1.15 yielding a risk of error amounting to 4.50 compared to the risk of error of 20 if a net margin method is applied.

With respect to illustration 3 which shows the greater sensitivity of the net margin method relative to the gross margin method to differences in capacity utilization by the tested party and the comparable, it would be helpful to note that the sensitivity of the net margin method to these differences will tend to decrease if the net margin method is averaged using multiple years of data in accordance with existing paragraph 1.50 of the TP Guidelines.

With respect to the appropriate standard for aggregating transactions, the Issue Note describes situations where taxpayers adopt a portfolio approach as a business strategy whereby certain transactions are bundled and their profitability evaluated on a combined basis for management purposes (e.g., equipment and captive aftermarket consumables). If taxpayers document their intent to adopt a portfolio approach as a business strategy and it is reasonably targeted, the Working Party notes that the transfer price for these transactions may be testing by bundling/aggregating these

transactions and evaluating their overall profitability. While the Working Party notes that the existing TP Guidelines require consideration of a business strategy as part of a comparability analysis (see, for example, paragraphs 1.31 through 1.35 of the TP Guidelines), KPMG would recommend adding a paragraph in the amended TP Guidelines that would specifically permit bundling and testing the transfer price on an overall basis for these closely related transactions. As noted in our earlier response of August 2006 to the OECD Invitation to Comment on Transactional Profit Methods, tax authorities frequently “cherry pick” by focusing on individual products or product lines that should logically be analyzed as a group.

The Issue Note states that when aggregating either the taxpayer’s transactions or those of the third party it is essential to ensure that taxpayer’s profit in the aggregated transactions can be compared in a reasonably reliable manner to the profits associated with the aggregated transactions of the third party in light of the five comparability factors set forth in Chapter I of the TP Guidelines. KPMG recommends that the TP Guidelines be amended to (a) explicitly acknowledge the distortions that potentially arise when the profitability of a narrowly defined product group in the controlled transaction is compared to the profitability of the third party averaged over a broad range of products and/or countries which significantly reduces its variability, and (b) permit averaging the results over a longer period to reduce the volatility (and the resulting distortion) arising from differences in the product grouping between the controlled and uncontrolled transactions.

#### **Issue Note 6 – Application of the Transaction Net Margin Method: Selection and Determination of the Net Profit Margin Indicator**

This Issue Note sets forth the principles that would govern the selection of a net margin indicator when applying the TNMM to evaluate the arm’s length price in a controlled transaction. Various measurement issues such as which costs and assets to include in calculating financial ratios such as the net cost plus or return to assets and the treatment of pass through costs that arise when the applying the TNMM are also discussed in the Issue Note.

The Working Party sets forth two broadly applicable principles in calculating the net profit margin in addition to those identified in existing paragraph 3.42 of the TP Guidelines: (i) The net profit margin should be calculated excluding non-operating items such as income taxes; similarly, exceptional and extraordinary items of a non-recurring nature also should generally be excluded. (ii) Financial items such as interest income and expenses should generally be excluded when applying the TNMM to non-financial transactions. KPMG would suggest that existing paragraph 3.42 be amended to include these two broadly applicable principles that should govern the calculation of the net profit margin in an application of the TNMM.

The Working Party sets forth four principles that should govern the choice of the appropriate base (e.g., net sales, costs or assets) for the net profit margin indicator: (1) The base should be

consistent with the comparability (including functional) analysis, (2) The base should reflect the main value-driver for the particular transaction, (3) The base should be reasonably independent from transfer pricing formulation, and (4) The base should be reasonably reliably measured and compared for the controlled and the uncontrolled transaction.

The principles identified by the Working Party in choosing the appropriate base for the net profit margin indicator are consistent with KPMG's experience in applying the TNMM. KPMG recommends that a new paragraph be added to the TP Guidelines that sets forth the above principles that would guide the taxpayer's choice of the appropriate base for the net profit margin indicator when applying the TNMM. KPMG suggests the following draft for the new paragraph which could follow existing paragraph 3.41:

3.41a In applying the transactional net margin method, the net profit margin should be determined relative to an appropriate base (e.g., costs, sales, assets) that a taxpayer realises from a controlled transaction based on the following considerations: (i) The base should be consistent with the comparability (including functional) analysis, (ii) The base should reflect the main value-driver for the particular transaction, (iii) The base should be reasonably independent from transfer pricing formulation, and (iv) The base should be reasonably reliably measured and compared for the controlled and the uncontrolled transaction.

With respect to choosing between an indicator such as a return on assets and any type of a profit margin measure (such as operating margin, Berry ratio, or net cost plus), KPMG is of the view that consideration may need to be given to the nature of the economic/business cycles in the particular industry. Specifically, the return on assets generally tends to be more sensitive to business cycles in the particular industry compared to a profit margin indicator. This arises from the stronger correlation over the course of a business cycle between the numerator and the denominator of a profit margin indicator (e.g., between operating profit and net sales when using an operating margin) since each is drawn from the income statement, as compared to a return on assets where the numerator is drawn from the income statement and the denominator reflects historical data from the balance sheet. Accordingly, to the extent that the taxpayer and comparable companies are in different stages of the economic cycle, a profit margin indicator may provide a more reliable basis to compare the results of the controlled and uncontrolled transactions. KPMG would suggest adding an illustration in the Issue Note illustrating the greater sensitivity of the return on assets to business cycle movements compared to a profit margin indicator.

KPMG is of the view that the Working Party's comment number 162 (pg. 52, 2008 Discussion Draft) unduly restricts the use of a Berry ratio as an arm's length remuneration for selling activities by limiting the remuneration for selling activities to a sales-related indicator. Specifically, KPMG would recommend modifying this comment to recognize that an arm's length remuneration for selling activities could also be based on a cost-based indicator such as a Berry ratio that reliably

measures the nature and intensity of the selling activities. The Working Party's limitation of the use of a Berry ratio to intermediaries and service providers is not consistent with Dr. Charles H. Berry's own determination that the ratio be used for pure distributors who may provide a number of services (such as advertising) in addition to performing buy-sell activities.

### **Issue Note 7 – Application of a Transactional Profit Split Method: Determining the Combined Profit to Split**

This Issue Note examines two issues that arise when applying a transactional profit split method: (1) the choice of the accounting standards for determining the combined profit that would be split when applying the transactional profit method, and (2) the selection of the profit measure – operating or gross profit - as the basis for the transactional profit split.

With respect to the accounting standards, the Working Party concludes that the OECD should not be prescriptive as to the choice of the accounting standards or the currency rate to be used in the determination of the combined profits and that a flexible approach should be favored so as to take account of the facts and circumstances of each case. The choice of the accounting standard should, however, be made in advance of applying the method, should be documented and should be applied consistently over the life time of the arrangement.

KPMG is in agreement with this approach given that there are no perfect or easy solutions to this issue. KPMG would recommend adding a provision to the TP Guidelines that where the taxpayer has calculated a consistent measure of profits applying a common set of accounting rules, tax authorities should respect the taxpayer's choice of the accounting standards used for purposes of applying the profit split. Moreover, taxpayers should be allowed to apply one common accounting standard in preparing the profit split analysis of all the related entities for each of the relevant tax jurisdictions. {This should address any concerns relating to amended paragraph 3.9 of the TP Guidelines}

While the Working Party notes that under the transactional profit split method the same principles should be applied to split losses as to split profits, KPMG recommends that the TP Guidelines be amended to explicitly acknowledge this guiding principle. As noted in KPMG's earlier response of August 2006 to the OECD Invitation to Comment on Transactional Profit Methods, loss splits may be especially common in the case of residual analysis. Since participants in many industries earn normal or routine profits in the long run, residual losses are just as likely as residual profits after providing the parties with the routine returns on their functions for which comparable benchmarks are available. A residual loss may simply reflect overestimation of the returns to the routine functions from an application of the TNMM which may be corrected by splitting the residual loss in a manner similar to the split of profits. KPMG would also recommend that in explicitly permitting the split of losses using the same principles as those used to split profits under a profit split method,

the TP Guidelines should also state explicitly that no inferences should be made that such an application of a profit split method constitutes a partnership between the related entities among whom the profit is being split.

KPMG would also recommend further clarification of the assertion in paragraph 182, pg. 56 of the 2008 Discussion Draft that “Experience shows that the use of multiple allocation keys to arrive at expenses and/or income attributed to the product-line or division may lessen the reliability of the data for these purposes” in light of the commonly accepted practice of using multiple allocation keys in other areas such as the allocation of headquarters costs (e.g., human resource department costs may be allocated to a division or entity based on the number of employees whereas marketing support costs may be allocated based on product sales or volume, etc.).

With respect to the use of operating or gross profit as the basis for a transactional profit split, the Working Party recommends that the choice of what measure of profits to use should depend on the facts and circumstances of the case and in particular on the comparability (including functional) analysis of the controlled transactions under review as well as the availability of comparable external data to support the profit split.

KPMG is in agreement with these recommendations since the choice of the profit measure is fact specific and taxpayers should be free to use the most reliable measure subject to documenting the basis for their selection.

### **Issue 8 – Transactional Profit Split Method: Reliability of a Residual Analysis and a Contribution Analysis**

This Issue Note discusses cases where a residual analysis can be more reliable than a contribution analysis and those where a contribution analysis can be more reliable than a residual analysis.

The Issue Note states that a residual analysis is generally more likely to be reliable where one or more parties to the transaction performs functions, uses assets or assumes risks for which an arm’s length return can be established (“the benchmarkable functions, assets and risks”) based on internal or external comparables using either a traditional transaction method or the TNMM. Where data on internal or external comparables are not sufficiently reliable to determine an appropriate return for the benchmarkable functions, assets and risks or where direct third party data can be used to determine the profit split, the contribution analysis may be more reliable than a residual analysis.

The Working Party has amended paragraph 3.19 in order to provide a clearer definition of the residual approach. The amendment replaces the references to the determination of the basic return in paragraph 3.19 with the determination of each party’s returns on its benchmarkable functions, assets and risks by reference to sufficiently reliable data on internal or external comparables.

KPMG's experience with the use of the contribution and residual analysis is consistent with the situations identified in the Issue Note under which the contribution and residual analysis, respectively, are likely to provide a more reliable measure of the arm's length result. KPMG also is in agreement that the revised paragraph 3.19 provides a clearer definition of the residual approach.

### **Issue 9 – Application of a Transactional Profit Split Method: How to Split the Combined Profit**

This Issue note sets forth general requirements that would govern the choice of the allocation keys used to split the combined profit when applying a transactional profit split method, some issues that arise in applying asset-based and cost-based allocation keys, and considerations relating to the use of external data in splitting the combined profit.

The general requirements governing the choice of the allocation keys that are used to split the combined profit under the transaction profit split method are similar in many respects to those governing the choice of the appropriate base for the net profit margin indicator when applying the TNMM and include: (1) Consistency with the comparability (including functional analysis) of the controlled transaction under review, and in particular with the allocation of risks among those parties, (2) Consistent with those which would have been agreed between independent parties in comparable circumstances, (3) Independent of transfer pricing formulation, i.e., based on objective data rather than data relating to controlled transactions, (4) Capable of being measured in a reasonably reliable manner, and (5) Consistent with the type of profit split approach (e.g., contribution or residual analysis).

The allocation keys that KPMG has used in applying the transactional profit split method are generally consistent with these requirements. While the Issue Note reviews a variety of allocation keys as well as various types of external data that may support the division of profits such as licensing, collaboration or other similar agreements, it does not address the use of rules or other similar licensing practices that taxpayers may have employed in negotiating licenses with third parties for purposes of approximating the division of profits in the controlled transaction. Where the controlled transaction involves the use of broadly similar intellectual property as that covered in arrangements taxpayers may have entered into with third parties, KPMG believes that such rules may provide a profit split rule that would approximate the division of profits in an agreement made at arm's length. KPMG would recommend adding a statement in section C – Reliance on external data of this Issue Note that would acknowledge the probative nature of these types of rules/practices employed by taxpayers in negotiating licenses with third parties in approximating the division of profits that would be agreed between independent parties under appropriate circumstances.

### **Issue 10 – Other Methods**

This Issue Note addresses the use of “other methods” to establish prices that satisfy the arm’s length principle. Examples of these “other methods” identified by the Working Party include the use of internal pricing models that might be used by the taxpayer in comparable uncontrolled transactions, pricing models such as the option pricing formula, the use of a discounted cash flow analysis in evaluating the income attributable to intangible property and fair market valuation approaches used in non-tax contexts. Specifically, use of pricing models that have been developed either internally by the taxpayer or licensed by the taxpayer from a third party and applied consistently in pricing intercompany and third party transactions in a consistent manner may provide the most reliable measure of an arm’s length result. For example, such pricing models may be used by taxpayers to determine royalty rates, arm’s length interest rates and insurance rates in a manner that satisfies the arm’s length principle.

While the Working Party does not rule out the use of these “other methods,” the Working Party takes the view that for these “other methods” to be acceptable “they must satisfy the arm’s length principle i.e. be comparable with what independent parties at arm’s length would have agreed to in comparable circumstances, in view of the comparability (including functional) analysis of the controlled transaction.” Taxpayer’s documentation should also include, according to the Working Party, an explanation of why OECD recognized methods were regarded as non-appropriate or non-workable in the circumstances of the case.

KPMG recommends that the Working Party clarify that a taxpayer may use one of the “other methods” if the taxpayer reasonably concludes that none of the OECD approved transfer pricing methods are likely to provide a sufficiently reliable measure of the arm’s length result. Because these “other methods” would ordinarily be used for evaluating a controlled transaction with a very unique and/or complex functional and risk profile for which no comparable transactions or data were available to apply the OECD approved methods, it may be difficult for a taxpayer to provide direct evidence that the “other method” satisfies the arm’s length principle. Accordingly, the taxpayer could provide the reasons that lead to the selection of one of the “other methods” rather than an OECD approved transfer pricing method.