Comments: Transaction Profit Methods, Discussion Draft For Public Comment

Manmeet Vij

Comments by : Manmeet Vij
Date : 30th April 08

Comments on: Transaction Profit Methods,
Discussion Draft For Public Comments

To

Dr. Jeffrey Owens,
Director, CTPA
OECD

Subject : Comments on Discussion Draft For Public Comments on Transactional Profit Methods.

Dear Dr. Owens,

It is a great step forward from OECD towards Transactional Profit Methods. I appreciate the efforts being put in to update the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax administrations ("TP Guidelines") to reflect the practical scenario.

I have given below my comments on the Draft. Para Number and the Page number have been provided for the comments presented.
The comments provide if there is any change suggested in the language of the Draft or / and other comments. In case only one of the two is there for a specific comment, the other is referred as NA.

I hope that the below given comments will be useful in the further development of the guidelines.

Best Regards

Manmeet Vij
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Serial No. : 1	Para: 52(iii)	Page No.: 27

OECD Draft Wording:

…"the tax administration of the country of the non – tested party also needs to have sufficient information to be able to review the application of the method to the foreign related party."….

Proposed Wording

…"the tax administration of the country of the non – tested party also needs to have sufficient information to be able to review the selection and application of the method to the foreign related party."….

Reason for Proposed changes

The wording given in OECD drafts suggests that the Tax payer is only needed to provide information relating to application of the method. However the Tax admin can also question the selection of method to find out the reasons why others (may be more direct) methods could not be used for the given controlled transaction. In my opinion even OECD does not intend to preclude this right of Tax Admin and therefore the word "Selection and" needs to be added.

Other Comments

The phrase "sufficient information" needs more elaboration stating what in particular the phrase "sufficient information" does or does not include. The same is equally applicable to Para 69 of this draft wherein the word "sufficient information" has again been used.

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Serial No. : 2	Para: 57	Page No.: 29

OECD Draft Wording:

the phrase “unique contribution” is used throughout this document to designate non-benchmarkable functions, assets or risk for which no sufficiently reliable comparable data are available.”

Proposed Wording

The phrase “unique contributions” is used throughout this document to designate non-benchmarkable functions, assets or risk ~~for which no sufficiently reliable comparable data are available~~”

Reason for Proposed changes

On page no. 63 of this draft, the note in the Box talks about adding the following definition to the Glossary
“Benchmarkable functions, assets and risks are functions, assets and risks for which reasonably reliable comparables exist”.
Now reading the definition of “unique contributions” keeping in mind the definition of “Benchmarkable functions, assets and risks” it feels that the wording “for which no sufficiently reliable comparable data are available” in Para 57 is repetitive and duplicative in nature and Therefore not needed.

Other Comments

NA

Comments by : Manmeet Vij
Date : 30th April 08

Serial No.: 3	Para: B-, B-1	Page No.: 32

OECD Draft Wording:

B - "Transactions involving intangibles and the Transactional net margin method"
B-1 "In what transactions involving intangibles can a Transactional net margin method be the most reliable method to use"

Proposed Wording

B - "Transactions involving unique contributions ~~intangibles~~ and the Transactional net margin method"
B-1 "In what transactions involving unique contributions ~~intangibles~~ can a Transactional net margin method be the most reliable method to use"

Reason for Proposed changes

There seems no specific reason to use the word Intangibles in please of the word unique contributions. Since the wordings under the subsequent paras (72 to 77) would hold equally true for unique contributions other than Intangibles.
Also the Headings B, B-1 stated above comes under Chapter 4. – Application of Transactional Methods and unique contributions . Heading A-1 and A-2 also uses the word Unique Contributions. Even para 74 under Heading B-1 itself uses the word "unique contribution" rather than intangibles. And therefore the word "Intangibles" should be replaced by "Unique Contributions".
Also in case the suggested change is not considered necessary than the reason for using "intangibles" in place of "unique contributions" should be explained.

Other Comments

NA

Comments by : Manmeet Vij
Date : 30th April 08

Serial No.: 4	Para: 133	Page No.: 46

OECD Draft Wording:

"…and / or to proceed with working capital adjustment"

Proposed Wording

NA

Reason for Proposed changes

NA

Other Comments

While doing the working capital adjustments, would it be enough to do the working capital adjustment only on the basis of financials of the comparables (which carries the risk of making the process a formulaic approach) or would the taxpayer be responsible to show that there exists a difference in the receivable / payable policy or Inventory policy that makes the Working Capital adjustment justifiable? e.g. the comparables may have lesser Debtors to sale ratio than the tested party. This may happen due to either tested party giving more credit days or this may also happen that the same is result of Tested party spending lesser amount on the function that is responsible for collection of debtors (which may make the adjustment un-justified).
(Even the example provided for Working Capital Adjustment on page 57 of Comparability Draft issued on 10 May, 2006 also makes the adjustment on the sole basis of Financials with out regard to any other information)
Therefore further guidance would be needed for calculating Working Capital Adjustment which should focus on the practical difficulty that a tax payer may have to demonstrate such differences (in Credit / Inventory policy) and collecting internal policies of comparables Vs reliability of the working capital adjustment on the basis of data contained in financials with out any further information.

Comments by : Manmeet Vij
Date : 30th April 08

Serial No.: 5	Para: 164(iii)	Page No.: 52

OECD Draft Wording:

"it not perform any other significant function (e.g. manufacturing function) that should be remunerated using another method or financial indicator."

Proposed Wording

"it <u>does</u> not perform any other significant function (e.g. manufacturing function) that should be remunerated using another method or financial indicator."

Reason for Proposed changes

It seems to be a typing error.

Other Comments

NA

Comments by : Manmeet Vij
Date : 30th April 08

Serial No.: 6	Para: 172	Page No.: 54

OECD Draft Wording:

"It was suggested that depending on the industry, it may be useful to look at other denominators where independent data may exist, such as : square metres of retail points, weight of product transported, number of employees, time, distance etc."

Proposed Wording

NA

Reason for Proposed changes

NA

Other Comments

While it is welcome to have such denominators in industries where a great amount of correlation is found among such units (weight, Number of employees etc.), the same have to be used with great care. The tax payer must be prepared to show from where it has got the data for comparables and its reliability since the same are not required to be reported as part of audited financials in majority of countries. Also one has to be extra cautious because of new arrangements these days e.g. some employees of tested party / Comparable may not be on its payroll (due to outsourced employees which would not be counted in Number of employees of tested / comparable parties). Also among Multinational Enterprises, some time there are arrangements that one AE appoints a person on its payroll working for other AE and the other AE reimburses such cost to first AE. In this case also while the employee effectively is working for second AE but for legal / reporting purpose it might be an employee of first AE. Further Development in this regard would be desirable.

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Serial No.: 7	Para: 183	Page No.: 56

OECD Draft Wording:

“In other words, the transactional profit split only determines which profit (or losses) should be attributed to the parties to a control transaction.”

Proposed Wording

“In other words, the transactional profit split only determines which <u>and how much</u> profit (or losses) should be attributed to the parties to a control transaction.”

Reason for Proposed changes

The profit split method aims at allocating arms length profit to parties to a control transaction on the basis of some economically valid criteria and not only at determining which profit should be allocated.
The same is also referred in Para 3.5 of the TP guidelines which reads as “ The profit split method first identifies the profit to be split for the associated enterprises from the control transactions in which the associated enterprises are engaged. It then splits those profits between the associated enterprises on an economically valid basis that approximates the division that would have been anticipated and reflected in an agreement made at arms length”
Therefore a corresponding change should be done in Para 183.

Other Comments

NA

Comments by : Manmeet Vij
Date : 30th April 08

Serial No.: 8	Para: 184	Page No.: 56

OECD Draft Wording:

"This section discusses different possible measures of profits arising from controlled transactions…"

Proposed Wording

"This section discusses few of the different possible measures of profits arising from controlled transactions…"

Reason for Proposed changes

The purpose of the Para 184 is to give idea about what different variant of profits can be used while applying a transactional profit split method. In my opinion, OECD does not intend to show that the given variant of profits is the exhaustive list and no more variant can be used while applying a transactional profit split method. Therefore OECD should suggest that this is only indicative list and not exhaustive list by adding the words "few of the" before "possible measures".

Other Comments

NA

Comments by : Manmeet Vij
Date : 30th April 08

Serial No.: 9	Para: 209	Page No.: 62

OECD Draft Wording:

"when applying a transactional profit split method, in general, a residual analysis is likely to be more reliable than a contribution analysis where one or more party(ies) to the transaction perform(s) functions, use(s) assets or assume(s) risks (hereafter the "benchmarkable functions, assets and risks") for which an arm's length remuneration can be determined using either a traditional transactional method or a transactional net margin method, on the basis of comparisons with comparable uncontrolled transactions (whether internal or external comparables)….'

Proposed Wording

when applying a transactional profit split method, in general, a residual analysis is likely to be more reliable than a contribution analysis where one or more party(ies) to the transaction <u>also</u> perform(s) functions, use(s) assets or assume(s) risks (hereafter the "benchmarkable functions, assets and risks") for which an arm's length remuneration can be determined using either a traditional transactional method or a transactional net margin method, on the basis of comparisons with comparable uncontrolled transactions (whether internal or external comparables) <u>apart from performing non benchmarkable functions, using non benchmarkable assets and/or assuming non benchmarkable risks</u>**….."**

Reason for Proposed changes

The reading suggests that the residual analysis is likely to me more reliable where one of the party(ies) performs benchmarkable functions, assets and risks. It does not state that the party should also be performing non benchmarkable functions, assets and risks. Then profit should be allocated first for the benchmarkable functions, assets and risks and then for non benchmarkable functions, assets and risks.

Other Comments

NA

Comments by : Manmeet Vij
Date : 30th April 08

Comments on: Transaction Profit Methods,
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Serial No.: 10	Para: B-, 212	Page No.: 64

OECD Draft Wording:

When a contribution analysis can be more reliable than a residual analysis
Para 212 “where it is not possible to apply a traditional transaction method or a transactional net margin method to allocate an arm’s length initial remuneration for benchmarkable functions performed, assets used and risks assumed….” .

Proposed Wording

NA

Reason for Proposed changes

NA

Other Comments

The inference that can be drawn from the reading of the above given Para is that the situation where contribution analysis can be more reliable than residual analysis is one where the residual analysis cannot be applied at all. Because if the benchmarkable functions / assets / risks cannot be allocated an arm’s length remuneration, it means that residual analysis cannot be applied.
Given this, does OECD wish to convey that Residual profit split method is always preferable to profit split on Contribution analysis?

Comments by : Manmeet Vij
Date : 30th April 08

Serial No.: 11	Para: 218	Page No.: 65

OECD Draft Wording:

Para 218
3.6"….the allocation of profit is based on the division of functions (taking account of division of the assets and risks) between the associated enterprises themselves…."

Proposed Wording

3.6"….the allocation of profit is based on the respective value of functions performed ~~division of functions~~ (taking account of ~~division~~ respective value of the assets used and risks assumed) between the associated enterprises themselves….".

Reason for Proposed changes

The allocation of profit is not simply on the basis of division of functions, since one AE which may be performing more functions in numbers while may be adding lesser value to the control transactions.
The same is also recognized on amended Para 3.16 on Page 66 where it is written that "In the absence of such reliable data, it **(**allocation of profit**)** is often based on the relative value of the functions performed by each of the associated enterprises participating in the control transaction, taking account of their assets used and risk assumed.
Therefore the word "division" should be replaced by "respective Value"

Other Comments

NA

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