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via E-Mail

Ms. Caroline Silberztein
Head of Transfer Pricing Unit
Centre for Tax Policy & Administration
OECD, 2 rue André Pascal, 75016 Paris

Re: Comments on Transactional Profit Methods; Value Added Versus "Pass-Through" Costs

Dear Ms. Silberztein:

As we discussed on November 10, 2006, this letter presents suggestions from clients in response to the OECD's request for comments from the public with respect to the potential for increased usage of profit-oriented methods, in particular, the transactional net margin method ("TNMM").

We apologize for providing you with this information after the OECD date for receiving comments, but we hope that the OECD will nonetheless consider, and then publish guidance to taxpayers and tax administrators on, the topic raised in this letter. Also, we would be pleased to supplement this letter with additional information and explanations.

This letter concerns the general need for sensitivity, as noted in paragraph 3.41 of the *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, in the pricing analysis in TNMM situations, particularly where a mark-up

on cost or operating margin approach is used, relevant to distinguishing between (1) a company's "internal costs" (*i.e.*, labor costs, depreciation) of conducting an activity for an affiliate (*e.g.*, manufacturing or services); and (2) the "external costs" it incurs that are associated with that activity (*e.g.*, buying components from another party for use in the company's manufacturing; subcontracting a portion of the company's required services to another party).

"Internal costs" are sometimes referred to as "value-added costs". It is generally accepted from an economic perspective that a company's value added costs consist of its labor costs and depreciation. The "external costs" are sometimes referred to as "non-value added" or "pass-through" costs.

The phrase "pass-through" costs also refers to the fact that in third party contracts a hiring party generally is unwilling to pay the counterparty (*i.e.*, contractor) a mark-up for the mere purchase of components or services provided by the counterparty's suppliers (or by the hiring party). For example, in manufacturing a product for the hiring party or in providing services to the hiring party, the counterparty may purchase components or services from another entity. Alternatively, the hiring party itself may provide components or services to the counterparty for the latter's use in its work for the hiring party. In either case, the counterparty would generally not receive a profit as a result of

these purchases since a mere purchase does not add value to the final product.¹ There is, of course, value added in the products or services themselves that are purchased by the counterparty. However, the associated profit is already embedded in the price of the purchased products and is received by the suppliers themselves since they are the ones that added the value. Likewise, the counterparty will be compensated only on its internal activities and costs (value added activities and costs).

Another type of situation where similar sensitivity is required when using TNMM on a cost plus or operating margin basis is where the tested party operates in a "buy-sell" manner (*i.e.*, taking title to supplied components and selling the finished product), but the TNMM comparables operate in part or in whole on a consignment basis (or vice versa, where the tested party is a consignee and the TNMM comparables are buy-sell).² Even though the buy-sell and consignment functions of the tested party and TNMM comparables may be identical, the financial statements of the two will show very different amounts of "total costs" (and sales), even at the same volume of activity.

Thus, when using TNMM, important comparability and reliability considerations can arise when the transfer pricing benchmarks consist of the financial results of publicly-

¹ An exception to this is for the time value of money if the counterparty funds the third party purchases or its own inventory, in which case the hiring party may agree to compensate the counterparty for this use of its working capital.

² It may not be clear in some cases whether the TNMM comparables operate on a buy-sell or consignment basis, or a mixture of the two types of arrangements. In cases where publicly available financial statements do not explain which arrangements are made, or if they state that both types of arrangements are used, then it will be necessary to resort to the value added cost analysis of the TNMM comparables and of the tested party discussed here in order to assure that the TNMM achieves reliable results.

traded companies. When TNMM uses “cost-plus” or operating margin the significance of the distinction between value added costs and “non-value added” or “pass-through” costs becomes greatest when (1) it is likely that the tested party and the TNMM comparables have only a general level of functional and other comparability; (2) it is apparent or likely that the tested party has a higher or lower level of value added activities and costs than do the TNMM comparables (e.g., when comparing a company that only assembles or finishes products with TNMM comparables that are fully integrated manufacturers); or (3) the tested party and comparables may be functionally similar or even have similar levels of value added costs, but one acts on a buy-sell basis and the other on a consignment basis. In such circumstances, unless one can distinguish between value added costs and total costs of the TNMM comparables, as well as of the tested party, there can be a substantial overstatement or understatement of the arm’s length return for the tested party when using a “total cost-plus” or operating margin (using total costs). Thus, the latter approaches will be unreliable.

This issue is illustrated by the following example:

Assume Company A has value added cost of \$50 and purchases of \$50. Further assume that every dollar of value added costs yields a profit of 20 cents. Then Company A’s overall profit is \$10, its return on value added costs (“ROVAC”) is 20 percent ($= \$10 / \50) and its return on total costs (“ROC”) is 10 percent ($= \$10 / \100). Economically speaking the \$10 is connected to the \$50 in value added costs. Economists are of the view that value added activities, and only value added activities, yield profit. But, practically speaking, one may not be able to observe the \$50 value added costs of Company A (a publicly traded company) with complete precision. Company A would report the \$100 of total cost in its profit and loss statement and an ROC of 10 percent.

Assume that tested party (a party engaged in a transaction with an affiliate) bears total costs of \$200, including component purchases of \$100. If one uses Company A as the arm's length benchmark in this case, then this would require the tested party to earn a 10 percent markup on all of its costs or \$20. This result is accurate only because, in this case, Company A's value added costs as a percentage of total costs is the same as that of tested party. That is, if one had information on value added costs for both Company A and tested party, and used Company A's ROVAC to set tested party's profit, one would arrive at the same result.

However, what if the tested party's value added costs are only \$20, or 10 percent of its total cost? Then the "true" arm's length profit for tested party is, in this case, \$4 which is 20 percent of value added cost, exactly the ROVAC exhibited by Company A. But use of Company A's ROC in this case yields a profit of \$20 ($= 10\% * \200). This profit amount yields an ROVAC for the tested party of 100 percent ($= \$20 / \20). The substantial error caused by the ROC is due to the fact that Company A's ratio of value added costs to total costs is different from that of the tested party.

The above example illustrates circumstances where a "total cost" TNMM approach is unreliable.

In some cases, the financial statements and other public documents of TNMM comparables break out a company's value added costs (*i.e.*, labor costs and depreciation) from its total costs. In cases where value added costs are not explicitly identified as such, they can nonetheless be derived from other public information such as the number of employees the company has and a published wage rate for the industry in which the company operates. That information, coupled with the amount of the company's actual depreciation set forth in its published financial statement, can provide a highly reliable estimate of the TNMM comparable's value added costs. With that information in hand, one can derive a mark-up on the TNMM comparables' value added costs (*i.e.*, operating profit over the value added costs derived as just indicated).

This markup will be more reliable than the markup on total costs in the cases discussed here. In fact, in such cases it would not be appropriate to base the markup or margin on the TNMM comparables' total costs. Thus, it will be important for the OECD to explain that use of such derived or partially estimated value added costs will increase the reliability of the TNMM approach and should be used to avoid a substantial overstatement or understatement of the arm's length return for the tested party that would otherwise result.

The above example can also be used to show that using ROVAC *with even a poor estimate of value added costs* is superior to the ROC depending on the "comparable."

Assume that one estimates Company A's value added cost range to be \$25 to \$75. This range represents a 50 percent error above and below Company A's actual value added costs of \$50. Then the estimate of Company A's ROVAC ranges from 40% percent ($= \$10 / \25) to 13.3% ($= \$10 / \75). So, if one uses these estimated ROVACs to set the tested party's profit, then the tested party's arm's length profit would fall between \$8 ($= 40\% * \20) and \$2.6 ($= 13.3\% * \20).³ This range is much closer to the "true" answer even though value added is estimated with error.

In reality, such a substantial error is unlikely for those cases where not all value added cost information for a company is disclosed and estimates have to be made. This is because, as mentioned above, depreciation is reported in the financial statements of public companies and most companies disclose the number of their employees. In such cases, the only missing number will be the labor costs per employee. These labor costs

³ This is contrasted to a ROC profit amount of \$20, where the different levels of value added costs are not taken into account.

are typically collected by government organizations and are published on an industry average basis.

In closing, our clients request that future OECD guidance on TNMM uses of "cost-plus" and other methods should mention the need:

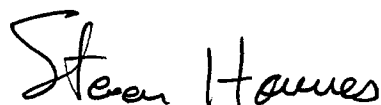
1. To be sensitive, in choosing TNMM comparables, to differences between the amounts of value added costs, relative to total costs, of the tested parties and of the TNMM comparables, respectively;
2. Not to use "total cost" or operating margin (using total cost) TNMM approaches where there is a material difference in the ratios of value added to total costs of the TNMM comparables and of the tested party, respectively, because a TNMM using a markup on total costs (or similar operating margin) will not be reliable in these circumstances.
3. In determining the arm's length cost-plus markup or margin⁴ from the TNMM comparables, use their value added markups or margins in order to make the TNMM more reliable in circumstances such as those described in this letter; and

⁴ A separate matter concerns whether in such cases the amounts of the mark-up or operating profit of such "comparables" are truly reliable or need to be adjusted. For instance, if the comparables own valuable trademarks but the tested party does not, then this needs to be addressed. Making the adjustments recommended in this letter for differences in the ratios of value added to total costs will not solve this other type of comparability or reliability issue.

4. To determine the value added costs of TNMM comparables either by reference to:
 - a. actual data on the value added costs of the TNMM comparables; or
 - b. a combination of actual data (e.g., depreciation) and estimates (e.g., average industry labor costs per employee) in cases where actual data on some of the value added costs of the comparables are not publicly available (e.g., sometimes labor costs of a comparable are not explicit, but the comparables' number of employees is disclosed).

Thank you for the opportunity to make this presentation on the value added cost issue on behalf of our clients. We look forward to discussing this further with you.

Sincerely,



Steven P. Hannes