

COMMENTS ON TRANSACTIONAL PROFIT METHODS

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Issue 1 – Status of transactional profit methods as last resort methods

DESCRIPTION: In the 1995 TP Guidelines, traditional transaction methods are regarded as preferable to other methods (see paragraphs 2.49 and 3.49 of the Guidelines). Transactional profit methods are described as last resort methods the use of which should be 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.

COMMENTS:

Introduction

The OECD Guidelines establish a hierarchy of methods that can be used in the examination of transfer prices.

The traditional transaction methods are at the top of this hierarchy (before the transactional profit methods). They include the comparable uncontrolled price method, which is preferred over the cost plus and resale price methods. *“The most direct way to establish whether the conditions made or imposed between associated enterprises are arm’s length is to compare the prices charged in controlled transactions undertaken between those enterprises with prices charged in comparable transactions undertaken between independent enterprises. [...] However, there will not always be comparable transactions available to allow reliance on this direct approach alone, and so it may be necessary to compare other less direct indicia, such as gross margins, from controlled and controlled transactions.”* [OECD Guidelines, 1995]

The transaction profit methods follow in the hierarchy. Transaction profit methods are *“other approaches that might be used to approximate arm’s length conditions when traditional methods cannot be reliably applied alone or exceptionally cannot be applied at all”*. [OECD Guidelines, 1995]

With the exception of the comparable uncontrolled price, which is based on a direct comparison of prices, traditional transaction methods are generally based on an examination of gross margins, whereas transaction profit methods are generally based on an examination of net margins.

The subsequent paragraphs are a comparative analysis of the relevance of a hierarchy between the net and gross margin approaches, that is, in other words, between traditional transaction methods other than a comparable uncontrolled price method and transaction profit methods.

When transaction profit methods should be used

The direct examination of net margins, without accounting for gross margins, may ease the task of tax administrations and small and medium enterprises. It enables small and medium enterprises to reduce the cost of their transfer pricing documentation, while making it possible for tax administrations to perform quick and simplified assessments of their tax positions.

GAAP inconsistencies across countries are more significant at the gross margin than at the net margin level. As a result of this, the use of gross profit ratios can lead to less reliable results than the use of net profit ratios in studies based on comparables data from different countries (such as pan-European studies).

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This is so unless adjustments can be performed to account for such differences. Generally speaking, it is relatively easy to adjust for such differences internally (at the tested party level) due to having access to segmented management accounting data, but it is more difficult to do so for companies established in countries where such segmented management accounting data are not publicly available, as is the case in Europe (unlike in the USA).

There are several examples of GAAP differences, among which, for example, differences in the recording of salary expenses in the U.K. versus the French GAAP. Whereas, according to the U.K. GAAP, salaries expenses associated with the manufacture of a product are recorded “above the line” as cost of goods sold, according to the French GAAP, such expenses are recorded “below the line” as other operating expenses. A direct comparison of the gross margins of a U.K. and a French manufacturer would therefore be inaccurate.

Not only are GAAP inconsistencies more significant at the gross margin than at the net margin level, but, as a result of these inconsistencies, gross margin data are, generally speaking, unavailable in publicly available databases of companies located in more than one country. This makes it oftentimes impossible to perform analyses at the gross margin level.

It follows from the above that GAAP inconsistencies across countries support the use of net margin analyses in studies involving more than one country. In this respect, a white paper presented to the Joint Transfer Pricing Forum of the European Union in March 2003, has provided some comfort, after having concluded, based on a statistical analysis of net margins, that Europe could be considered as one market for comparables searches purposes.

When the examination of gross margins indicates that transactions were performed at arm’s length, while the examination of net margins leads to the opposite conclusion, it shows that “below the line” expenses, in the form of service charges, royalty fees, or inadequate allocation of revenues given functions performed, risks incurred and transactions not yet characterised, might have inappropriately reduced the company’s net margin. In this case scenario, we believe that focus should be brought to indirect costs and net margins examined as a necessity.

These thoughts support the use of net margins in studies involving several countries.

When traditional transaction methods should be used

When appropriate data is available, however, it might be better to use traditional transaction methods than transaction profit methods.

When the net margins of the comparable companies are polluted by irrelevant indirect costs, an examination of gross margins would produce more accurate and reliable comparison than that of net margins. An examination of gross margins would be preferable as well for companies that perform several activities, since these are not, generally speaking, recorded separately in their statutory accounts (with the exception of US companies). In other situations, the use of a net margin method could also make the comparison between controlled and uncontrolled transactions less precise due to a higher number of variables involved.

Generally speaking, we believe that in cases where a company’s activities are best reflected with “above the line” expenses, traditional transaction methods should remain the most appropriate transfer pricing methods. Direct costs are most significant for some functions, such as manufacturing or distribution, and potentially in some industries as well. This is for example the case of manufacturers’ operating expenses other than cost of goods sold, which are not directly relevant to their activities as manufacturers. In these circumstances, it makes sense to only consider transactions at the gross margin level.

In addition, the interactions between transfer prices and custom values support the use of gross margin methods when these can be applied with reasonable reliability. Custom authorities tend to analyse prices rather than margins, which are arguably closer to a gross margin analysis than a net margin analysis. In the view of the reconciliation of transfer prices and custom values, which has given rise to a conference co-organised by the OMC and the OECD, keeping gross margin methods seems critical.

At last, the bringing together of methods for assessing the tax basis for VAT and the arm's length principle, as has just happened in Belgium, supports the use of gross margin analyses in countries where gross margin data is available in the public domain. A gross margin analysis would be more relevant than a net margin analysis for trades of goods or services recorded "above the line" (sales of finished products, purchases of raw materials or semi-finished products, purchases of quality control services), whereas the opposite would apply to trades of products or services recorded "below the line" (purchase of marketing services for example).

These thoughts support the use of gross margins in relevant circumstances.

Conclusion

All these thoughts lead us to consider that the choice of a transfer pricing method depends, above all, on its accuracy and reliability, which itself depends on economic, methodological, and accounting factors, but not on the hierarchy of methods currently prescribed by most national or international standards.

In light of the above analysis, we would recommend adopting a system based on a kind of "best method rule", since, while it is sometimes the case that a net margin method is preferable to a gross margin method, the opposite happens as well.

This recommendation is supported by the fact that there exist national standards that implicit or explicitly imply a "best method rule", rather than a hierarchy between traditional transaction methods and transaction profit methods.

The French and the US legislations are among the nations where such standards apply. According to the French legislation, any transfer pricing method is acceptable as long as it is justified by sound economics, methodology, and accounting. French legislation refers to the use of gross margin methods as being acceptable to the same extent as net margin methods.

In the French legislation, when it is not possible to determine the extent of the national and foreign operations, it is necessary to allocate income according to two available methods: one of proportional allocation and one based on comparison. The proportional allocation method consists in applying a coefficient to the global benefit of the company, thus resulting in the computation of the national and foreign share of the benefit. The allocation can be based on expenses, invested capital, gross benefit, or other items such as volume. The use of a ratio of gross profit of the national or foreign entity to gross profit of the company as a whole necessitates sufficient availability of management accounting information.

The comparison method can be used as an alternative to the proportional allocation method and consists in determining the national and foreign profit through comparing them to the profit earned by independent companies. The result can be obtained through applying an average gross benefit percentage coefficient to the turnover of the company or, alternatively, an average net benefit percentage coefficient.

Issue 2 – Use of a transactional profit method either in conjunction with a traditional transaction method or as a sanity check to test the plausibility of the outcome of a traditional transaction method.

DESCRIPTION: The 1995 TP Guidelines do not require the application of more than one method and indicate that it will generally be possible to select one method that is apt to provide the best estimation of an arm's length price. However, for difficult cases, where no one approach is conclusive, a flexible approach would allow the evidence of various methods to be used in conjunction. In such cases, an attempt should be made to reach a conclusion consistent with the arm's length principle that is satisfactory from a practical viewpoint to all the parties involved, taking into account the facts and circumstances of the case, the mix of evidence available, and the relative reliability of the various methods under consideration (see paragraph 1.69 of the 1995 TP Guidelines).

In addition, practical experience acquired by taxpayers and tax administrations since the TP Guidelines were approved in 1995 shows that in some cases a transactional profit method (profit split or transactional net margin method) is applied either by the taxpayer or by the tax administration to test the plausibility of the outcome of a traditional transactional method that is used as the primary transfer pricing method, for instance where the results of applying a traditional method are uncertain.

COMMENTS:

Introduction

It is often useful to corroborate a traditional transaction method, such as a comparable uncontrolled price or transaction, a cost plus, or a resale minus method, with a profit transaction method. On the one hand, comparable uncontrolled prices or transactions are not always reliable due to differences in products, geographic zones, and the economic conditions of the transactions. On the other hand, cost plus and resale minus methods can be unreliable due to the use of gross margins.

Testing a traditional transaction method with a transaction profit method

Performing such an additional analysis based on a transaction profit method can be necessary, as in the case scenarios described below.

First, when the examination of the gross margin leads to the conclusion that trades of goods or services were performed at arm's length, while the examination of the net margin leads to the opposite conclusion, it is a sign that "below the line" expenses (in the form of service charges, royalty fees, transactions not yet characterised, or inadequate allocation of revenues, given functions performed and risks incurred), might have inappropriately reduced the net margin of the tested party.

This, however, is not necessarily the case, as there can be situations where the allocation of risks between an entrepreneur and a low-risk entity has resulted, by virtue of an agreement, in the definition of a cap to a specific cost category of the low-risk entity, say inventory costs for example. Let's assume that the low-risk entity has mismanaged its inventory costs, so that they exceed the cap defined by the agreement. By virtue of the agreement, the amount by which the cap is exceeded will remain to be paid by the low-risk entity, therefore resulting in a decrease of its net margin by the same amount, while its gross margin remains the same. Here, the reduction of the net margin of the low-risk entity results from its inefficient management of inventory costs rather than a shift of the burden of the risk that could have accrued to the entrepreneur. The fact that the net margin of the low-risk entity falls below the interquartile range of comparable net margins, as long as it matches the amount by which the cap has been exceeded, should not be interpreted as the sign of an inappropriate transfer pricing policy. As a result, in these specific circumstances, the net margin can serve as a test of the gross margin analysis.

Second, further to the international standards established, most significantly, by the OECD, many tax authorities consider the comparable uncontrolled price or transaction methodology as their priority when there is sufficient data available for it to be applied. However, its mere application can have significant limitations when disconnected to the economic circumstances of the intercompany transactions being examined. Such an issue generally arises in the case of licences of intangible assets. The intangible assets licensed do not always produce the same level of revenues for all the licensees, especially when they operate in different markets with different competitive and economic conditions. In these circumstances, an examination of operating profit can usefully confirm that the tested party can sustain the royalty rate determined under the comparable uncontrolled transaction analysis and, if not, how it should be adjusted.

In these case scenarios, we believe that a supplementary analysis based on net margins should be performed to ensure a comprehensive examination.

Testing a transaction profit method with a traditional transaction method

Inversely, the examination of a comparable uncontrolled price or transaction relatively to a transactional net margin method can be necessary.

Double taxation can take place either in case of a transfer pricing adjustment on the part of a tax administration or in case of an adjustment on the part of a custom administration. In most cases, custom administrations use the transactional value method in order to determine the custom value of a product. The transactional value method is more or less the custom equivalent to the comparable uncontrolled price or transaction method used by tax administrations for transfer pricing purposes.

From the standpoint of a custom administration, there is no reason to apply different values to the same products. From the standpoint of a tax administration, however, there can be market-driven reasons which make it appropriate to apply different values to the same products. This is for instance the case when the same products are aimed at different industries. In the context of a transactional net margin method, such factors are accounted for in the determination of an arm's length transfer price.

Let's consider the case of a group involved in the manufacturing and distribution of electronic products around the world. Suppose that the group's head office has developed and owns the intellectual property related to the manufacture of the group's products (technological intangibles) and their distribution (marketing intangibles).

The group's sales entities around the world undertake two types of sales: sales of stand-alone products, and sales of packages integrating a product and a solution. When purchasing products for resale, the group's head office is the entrepreneur in the transactions with the sales entities, which are remunerated based on a transactional net margin method.

However, when purchasing products for integration into a package (with imbedded intangibles), the group's sales entities increase the contents of their operations and share the profiles of entrepreneurs with the head office. The sales of packages therefore require remunerating the sales entities based on another transfer pricing method.

As a result of the application of different transfer pricing methods, the sales will be valued differently and give rise to two different prices for the same products.

The custom administration is likely to challenge the lowest value. Comparable prices are available in order to support the transactional value method, or they are not. If they are not, the taxpayer would be well advised, on caution grounds, to use the higher of the two values at clearance (despite the disadvantage of having to pay extra tax charges). If they are, the tax and customs values would be reconciled automatically, thus eliminating a potential source of double taxation. This is a strong

argument for examining a comparable uncontrolled price or transaction correlatively with a transactional net margin method.

Testing a transaction profit method with another transaction profit method

Besides, we believe that the OECD should not only consider the validation of transaction traditional methods by transaction profit methods but the corroboration of transaction profit methods by another transaction profit method as well. As illustrated below, in cases where a profit split method is applied purely based on internal data or where a small or medium enterprise has several different profiles or positions for a given product or service, a transaction profit method could be usefully supported by the application of another transaction profit method.

In theory, the selection of an appropriate transfer pricing method depends on reliability and comparability factors. In this respect, a comparable uncontrolled price can be selected as being the most appropriate method when comparable transactions with independent parties exist, or a transactional net margin method when only net profit ratios are available for comparison purposes. However, the approach for determining transfer prices is not always primarily chosen based on tax compliance matters but also on practical considerations such as customary (according to the industry in which the tested party operates) or ease of implementation of the transfer pricing method (as determined by the specific circumstances of the tested party).

Testing a profit split with a transactional net margin method

In case of a profit split method, there can be less focus on comparability issues because the key to the application of this method is to account for the remuneration of both parties to the transaction and select the most relevant factors to determine the split of the consolidated revenues. The factors selected are based on internal data such as management performance, value added, or contribution to intangible assets.

This does not mean that a corroborative test using a transactional net margin method would not be valuable, as it would provide comfort as to the appropriateness of the profit split based on external market data. In cases of diverging conclusions between the profit split method and the transactional net margin method, the conclusions of the profit split method should prevail above those of the transactional net margin method given that the profit split method was the one chosen as the most appropriate method for the tested transactions.

Let's consider the case of a manufacturer of automobile spare parts that splits profit based on value added. The split is that of profits accruing from the sales of finished products. The first entity provides the second entity with intermediary products which it has produced. The second entity processes them into finished products, before selling to final customers. Although it makes sense, in this situation, to use value added as the allocation key, since value added measures the difference between the value of the finished products and that of the intermediary products, which is precisely where value gets created through processing or manufacturing, the analysis can be usefully corroborated by external market data. Given the public unavailability of value added data, generally speaking, a transactional net margin method analysis can be valuably applied to the simplest entity to the transaction.

When the allocation key selected can be seen as a good indicator of the functions performed, assets owned, and risks incurred by the entities to the transactions, there will still be value in supporting the analysis with external data for corroborative purposes, even if it might be less. When the allocation key is not such a good indicator of the value created by the entities to the transactions, an analysis based on external data to corroborate the conclusions of the profit split analysis is necessary.

Testing a transactional net margin method with a profit split

In case of a transactional net margin method, when it leads to the conclusion that the results of a given tested party are arm's length, it might be useful to corroborate this conclusion with a profit split method, as it could be the case that a disproportionate amount of profit accrues to the tested party in comparison with the consolidated revenue of the transaction, and an appropriate method would ensure a fair allocation of income across entities.

Conclusion

As discussed above, not only are there benefits from testing a traditional transaction method with a transaction profit methods or from testing a transaction profit method with a traditional transaction method, but there are also benefits from testing a transaction profit method by another transaction profit method. In light of this discussion, our recommendation in a context of tax compliance would be to systematically supplement any analysis based on a given method by another method.

Further, this supports the adoption of a sort of "best method rule", rather than a hierarchy of methods, where the primary method would be the one that provide the most accurate and reliable results and the secondary method the second to best method.

Issue 3 – Application of transactional profit methods and intangibles

DESCRIPTION: Transactional profit methods are regarded as particularly useful in those cases where valuable or unique intangibles are used by each party to a controlled transaction because these are the cases where traditional methods are the most difficult to use. There is however limited guidance in the 1995 TP Guidelines on how transactional profit methods help taking into account the use of intangible assets in a controlled transaction.

COMMENTS:

In cases where the tested party owns significant intangible assets which it has licensed in the context of the sale of a product or a service and for which it receives a royalty fee, it can be useful to apply the transactional net margin method in order to assess the level of operating profit that the tested party would have earned if it did not receive a royalty fee but, instead, was remunerated for the intangible assets imbedded in the transaction directly through higher sales price. The level of operating profit of the tested party, after deducting the royalty fee payment, would be compared with the level of operating profit earned by comparable companies that did not own any significant intangible assets. If the level of operating profit of the tested party fell within the range of arm's length profit results found for the comparables, then it would support the view that the tested party is transacting at arm's length. This approach is connected to the relief from royalty approach used for valuation purposes. It can be used for corroborative purposes along with a separate investigation of an arm's length remuneration for the intangible assets but not on a stand-alone basis.

Another approach consists in assessing the impact of a royalty payment on the operating profit of the licensee. The application of a transactional net margin method remains useful as it provides a comparison between the operating profit of the licensee after paying the royalty fee with the operating profit of companies not being subject to such royalty payment. If the operating profit of the tested party falls within the arm's length range, it can be assumed that the royalty fee complies with the arm's length principle. However, this approach should be confirmed with a separate investigation of an arm's length royalty rate based on comparable license agreements but not on a stand-alone basis.

Issue 4 – Application of transactional profit methods and consideration of risks

DESCRIPTION: The importance of properly identifying the risks assumed by the parties as part of the functional analysis is highlighted at paragraphs 1.23 to 1.27 of the 1995 TP Guidelines. In practice there are issues in relation to the identification of risks and of the parties that assume, manage and bear the risks; valuation and determination of an arm's length reward for risks management and risk bearing; and assessment of an arm's length allocation of risks among the parties. A consideration of risk is found to be usually crucial in the application of the transactional profit methods. Comments are invited on how transactional profit methods can take into account the consideration of risks associated with a controlled transaction. Examples of pricing scenarios where the risk factor is of significance would be very helpful.

COMMENTS:

When the examination of gross margins and net margins lead to opposite conclusions in terms of compliance with the arm's length principle, it is necessary to further investigate “below the line” expenses in order to disclose any potentially inadequate service charges, royalty fees, transactions not yet characterised, or revenue allocations, given the profile of the entity under examination (in terms of functions performed, assets owned, and risks incurred) and the remuneration determined for it. Such inadequate service charges, royalty fees, transactions not yet characterised, or revenue allocations can cause the net margin of the tested party to be inappropriate for transfer pricing purposes, even when its gross margin is arm's length.

However, there can be situations where the allocation of risks between an entrepreneur and a low-risk entity has resulted, by specific provisions of an agreement, in some specific costs that could have been borne by the entrepreneur but are borne by the low-risk entity. The costs can be specific operating costs that derive from the activities of the low-risk entity, such as receivables and other related expenses occurring as an outcome of credit risk, in the case of a low-risk distributing entity.

By virtue of the agreement between the entrepreneur and the low-risk entity, the receivables and other related expenses will have to be paid by the low-risk entity, therefore resulting in a decrease of its net margin by the same amount, compared with the alternative situation where these expenses would be paid by the entrepreneur. The assessment of the net margin of the low-risk entity through a transactional net margin method could lead to an unfavourable conclusion for the company, if, as a result of these additional expenses, the net margin of the low-risk entity falls outside the range of arm's length net margin results.

It could however be argued that the reduction of the net margin of the low-risk entity has resulted from its inefficient management of credit risk (since a better management would have translated into lower expenses, thus resulting in the net profit of the low-risk entity falling inside the range of arm's length net margin results), rather than an inappropriate remuneration for it (in light of functions performed, assets owned, and risks incurred). This conclusion could be reached as long as the amount by which the net margin of the low-risk entity falls short of the range of arm's length results matches the amount of receivables and other related expenses incurred. In such a case, rather than being interpreted as the sign of an inappropriate transfer pricing policy, the fact that the net margin of the low-risk entity falls outside the arm's length range of net margin results could be interpreted as the reallocation of the credit risk from the entrepreneur to the low-risk entity, as agreed between the entrepreneur and the low-risk entity. This would amount to a restriction of the risks borne by the entrepreneur to some specific risks, with the other risks (credit risk in the example here) borne by the low-risk entity.

Issue 9 – Application of the transactional net margin method: standard of comparability

DESCRIPTION: The 1995 TP Guidelines contain some discussion of the comparability standard to be applied to the transactional net margin method (see paragraphs 3.34 to 3.40). Comments are invited on the following aspects:

- Paragraph 3.34 indicates that "[p]rices are likely to be affected by differences in products, and gross margins are likely to be affected by differences in functions, but operating profits are less adversely affected by such differences. As with the resale price and cost plus methods that the transactional net margin method resembles, this, however, does not mean that a mere similarity of functions between two enterprises will necessarily lead to reliable comparisons." To what extent can a lower comparability standard be applied in a transactional net margin method than in a traditional method and for what reason(s)?
- Experience shows that practitioners often apply the transactional net margin method by comparing the net margin earned by the taxpayer in a controlled transaction or set of controlled transactions with the company-wide net margin reported by third parties. In some other cases, it is the taxpayer's net margin that is determined on a company-wide aggregated level. To what extent do you consider the transactional net margin method can validly be applied using company-wide aggregated data (either on third party "comparables" or on the taxpayer's net margin)? To what extent can a lower standard for aggregating transactions be applied in the transactional net margin method than in a traditional method and for what reason(s)?

COMMENTS:

In addition to being less affected by product and functional differences than prices and gross margins respectively, net margins are more consistent across countries, which increases the reliability of comparison at the net margin level. When salary expenses would all be recorded "below the line" in the French GAAP, salary expenses of personnel directly involved in manufacturing would be recorded "above the line" in the UK GAAP. While the gross margins of a French and a UK company being compared would therefore cover different items, their net margins would cover the same items, thus enabling an apple to apple comparison.

When dealing with a conglomerate involved in several distinct activities, it is usually preferable to compare its activities on a stand-alone basis rather than on an aggregate basis. The comparables used for the analysis are required to match comparison criteria that are consistent with each of the activities. In some cases, however, it may make sense to compare the activities of the conglomerate on an aggregate basis. Such a comparison may be more reliable, as some structural differences that exist between a conglomerate and a company involved in a single activity might not exist between two conglomerates. Such a comparison can be made when conglomerates involved in the same activities or activities similar to those of the tested conglomerate can be identified and when consolidated financial data are available for the comparable conglomerates (in order to neutralise the potential distorting effect of non-arm's length transfer prices). We consider that such a comparison is acceptable even in cases where the comparable conglomerates are involved in additional activities that are not comparable to those of the tested party, as long as such additional activities do not represent a significant share of the conglomerates' total activities in terms of volume or margin rate.