**INVITATION TO COMMENT ON TRANSACTIONAL PROFIT METHODS**

**A PRACTITIONER'S RESPONSE TO THE OECD**

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## Introduction

The seminal document that offers guidance to both tax administrations and taxpayers on transfer pricing issues within the OECD countries is the Transfer Pricing Guidelines which were last published by the OECD in 1995. Although the document is quite comprehensive, one of its main drawbacks is the fact that the guidance offered is especially vague when it comes to the practical application of the various accepted transfer pricing methods. In particular, Chapter III which deals with the application of such methods only offers high-level guidance and this has resulted in much confusion within the transfer pricing community on how exactly these methods should in fact be applied. Indeed, during many tax disputes, OECD tax administrators and multinational taxpayers alike have sought to interpret them in different often mutually exclusive manner and this has resulted in much controversy in many of the major tax jurisdictions.

Given this scenario, Working Party No. 6 of the OECD Committee on Fiscal Affairs, which is responsible for transfer pricing issues began consultations with the public beginning in 2003 to address some of the practical shortcomings of the 1995 OECD Guidelines and to monitor the implementation of the 1995 Transfer Pricing Guidelines.

As part of this process, in a welcome new development, the OECD has begun a series of consultations with the transfer pricing community on the practical application of transfer pricing methods and especially the so-called transactional profit methods which are by far the most used methods in transfer pricing analyses. The Working Party has selected two areas to be considered in priority as follows:

- Comparability issues encountered when applying the transfer pricing methods authorised by the 1995 TP Guidelines (whether traditional transaction methods or transactional profit methods) and

- The application of transactional profit methods (i.e., the profit split methods and the transactional net margin method which are described in Chapter III of the 1995 TP Guidelines). It is expected that the ultimate outcome of the review of transactional profit methods should be a revision of Chapter III of the 1995 TP Guidelines.

As part of this consultative process, eleven issues related to the application of the transactional profit methods have been identified and comments have been invited from members of the transfer pricing community.

Given this important development, this paper outlines the issues that were identified by the OECD's Working Party No.6 and presents a series of responses from a practitioner's point of view. The main purpose of this paper therefore is to address not only the issues raised in a wider context and also to encourage a healthy discussion on the nuances of the application of the various transfer pricing methods. This is especially urgent since the implications of any revisions to Chapter III of the OECD Guidelines will have a far reaching and lasting impact on how the transfer pricing is addressed from a practical standpoint by both multinational taxpayers and tax administrations within the OECD.

## 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.*

*Please comment on:*

- *Whether you consider that the status of transactional profit methods as last resort methods is appropriate or whether you consider that this status should be revisited, and if so why. Please respond separately for the profit split methods and for the transactional net margin method.*
  - *Would your response to this question differ depending on whether the transfer pricing method is used to set the arm's length price of future transactions, or to test the outcome of already completed transactions at the year end or during an audit?*
- *Whether you consider that the use of transactional profit methods is particularly appropriate for specific industries / activities / transactions / business models and if so for what industries / activities / transactions / business models and for what reasons. Would you consider that there are specific industries / activities / transactions / business models for which the status of transactional profit methods as last resort methods should be reviewed? Would you consider that for those specific industries / activities / transactions / business models the transactional profit methods should be placed at the same level as the traditional methods (excluding CUP)? To the extent relevant please respond separately for the profit split methods and for the transactional net margin method.*
- *Whether you regard the use of transactional profit methods as an appropriate solution to situations where there are no comparable data available or where the available comparable data are not of sufficient quality to rely solely or at all on the traditional transaction methods. To the extent relevant please respond separately for the profit split methods and for the transactional net margin method.*
- *Any other remark you may have in relation to the hierarchy of methods in the 1995 TP Guidelines.*

**<u>Comments</u>**

### *Status of Transactional Profit Methods as "Methods of Last Resort"*

This is a very real and crucially important issue, especially when one considers the application of transfer pricing methods from a practical standpoint in relation to preparation of documentation for compliance purposes. In most instances where a multinational is preparing documentation, limiting the use of transactional profit methods to the so-called "exceptional situations" is practically impossible. Indeed, situations "where there are no data available or where the available data are not of sufficient quality to rely solely on traditional transactional methods" are certainly not exceptional but rather the practical reality in a vast number of cases.

### *Traditional Transactional Methods Application Constraints*

Among the traditional transactional methods, the only method that lends itself to practical application in the context of preparation of documentation with ease is the comparable uncontrolled price ("CUP") method. However, this is only possible provided good quality information on internal or external CUPs are available (and, even then, finding internal CUPs is far easier than finding external CUPs in most instances).

Given that finding comparable transactional data (internal or external) for the application of the other two traditional transactional methods (i.e. Resale Price and Cost Plus) is exceptionally difficult, most taxpayers have to resort to the transactional profit methods in many cases to defend the arm's length nature of their transfer prices.

Therefore, from a practical standpoint, especially when testing transactions for compliance purposes, it would be better to **NOT** relegate the use of the transactional profit methods such as the TNMM and the Profit Split Method as "methods of last resort" since taxpayers are forced to rely on them due to the lack of good quality transactional data to apply any of the traditional transactional methods.

### *Transactional Profit Methods Application*

In addition, the two transactional profit methods, TNMM and the Profit Split Method, lend themselves to practical application in different scenarios. Given the fact that the TNMM is a one-sided test, it is best applied to test "routine": returns of the simpler entity that does not contribute to the development of any valuable intangibles. On the other hand, the Profit Split Method naturally lends itself to application when intangibles are shared between entities and non-routine returns have to be substantiated in a transfer pricing context.

From the perspective of setting transfer prices, it may also be prudent to not relegate the transactional profit methods as methods of last resort since the strategic planning exercise within many multinationals is intimately tied to achieving specific profit margins. Therefore, the use of transactional profit methods to set transfer prices does in a way mimic the strategic planning exercise in many multinationals. Given the absence of an explicit CUP, it may be better to allow taxpayers to have some leeway to use either the other traditional transactional methods (Resale Price and Cost Plus) or the transactional profit methods (TNMM, Profit Split) to set transfer prices within the organizations.

### *Conclusions*

In sum, although one could certainly make a good case for the CUP method being the preferred method for setting transfer prices, it is much harder to argue, certainly from a practical standpoint and especially given the lack of good quality transactional data, that an explicit hierarchy should be imposed among the other transfer pricing methods. Ironically, in a vast majority of transfer pricing situations, taxpayers "resort" to the so-called "methods of last resort" to defend their transfer prices.

## 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 are invited on:*

- *Situations where the use of a transactional profit method in conjunction with a traditional method is found helpful or necessary, for what reasons, and how this can work in practice. Please respond separately for the profit split methods and for the transactional net margin method to the extent relevant.*

- *Situations where the use of a transactional profit method to test the outcome of a traditional method is found helpful or necessary, for what reasons, and how this can work in practice. Please respond separately for the profit split methods and for the transactional net margin method to the extent relevant.*

**<u>Comments</u>**

***Use of more than one Transfer Pricing Method***

From a risk management perspective, the use of more than one method does help, especially in situations where the results arrived at by the application of a traditional transactional method is unclear. In many instances, in fact, corroboration of transfer prices by the application of more than one method can be quite an effective defence during a transfer pricing audit proceeding.

From a practical standpoint, a transactional profit method is usually used to corroborate the results obtained by the application of a traditional transactional method. For instance, the results obtained by the application of the Resale Price Method for a routine distributor might be corroborated by the application of the TNMM. Such corroboration can also be used as a sanity check by both taxpayers and tax administrators, especially if intangibles are involved. For instance, since the TNMM can be used to test routine returns, its application can point to how much of a taxpayer's return can be attributed to routine functions and how much can be to non-routine functions that may generate intangibles. In the same vein, the use of the profit split method can also be useful to demarcate how much additional return is due to each of the entities involved in a transaction even if a traditional transactional method has already been applied.

## 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 are invited on:*

- *What the situations involving intangibles are where a profit split or transactional net margin method would be particularly useful,*

- *How a profit split or transactional net margin method may help taking into account the intangibles used in the controlled transaction.*

**Comments**

***Use of Transactional Profit Methods when Intangibles are Involved***

One compelling reason to consider transactional profit methods to be particularly important in many transfer pricing situations would undoubtedly be their usefulness when intangibles are involved in the context of a controlled transaction. One of the chief problems with the application of traditional transactional methods when intangibles are involved is the exceptional difficulty in identifying comparable transactions, whether internal or external, that involve the use of similar intangibles. Given that intangibles are, by definition, expected to be unique if they are to be a source of competitive advantage for any multinational company, the exercise to find comparables is at best an incomplete exercise and at worst, completely subjective.

Therefore, the use of transactional profit methods come in quite handy for they can be used effectively to differentiate between the so-called routine contribution to a company's margins and a non-routine contribution. For instance, given that the TNMM is used to test routine returns, its application may point to how much a company's margin can be attributed to routine functions. The TNMM, however, is only of limited use when intangibles are involved in a controlled transaction, perhaps to clarify whether non-routine returns exist.

In almost all cases where intangibles are involved, the best method to use is invariably the profit split methods. In particular, the residual profit split method is particularly useful to apply to determine the non-routine returns attributable to intangibles.

## 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**

***Consideration of Risks***

The consideration of the risks assumed as part of the functional analysis is certainly one of the key aspects of a transfer pricing analysis and does aid greatly in the application of the transactional profit methods. This consideration does help clarify the risks that have been assumed by the related parties involved in the controlled transaction and is also very important in terms of entity characterization. For instance, not only does this consideration of risk help in characterizing the entity under consideration as, for instance a distributor or a service provider but may also help to understand hybrid structures such as a distributor that also performs value-added assembly and/or manufacturing.

Further, a proper consideration of risks assumed can also provide some insight into whether the entity under consideration is taking on any additional risks that may have to be taken into account when comparisons are made to third party comparables. For instance, a distributor that takes on substantial logistics or foreign exchange risk in relation to its controlled transactions vis-à-vis other routine distributors might command a higher return than a distributor that is not extensively involved in such functions. In this context, third party comparables should be carefully examined to ensure and the arm’s length range is adjusted for this additional risk.

***Risk-Reward Considerations***

Given the risk-reward equation, i.e. higher the risk, higher the reward, it is clear that all other facts remaining the same, additional risk undertaken by an entity implies additional returns, i.e. an increase in the profit margins. Given that the transactional profit methods are used to compare profit margins of the entities under consideration to third party comparables, the consideration of risk is absolutely paramount.

In conclusion therefore, the consideration of risk is crucial to determine:

(1) The overall risk profile of the entities involved in the controlled transaction so that the entities can be characterized properly.

(2) Additional risks are identified so that they can be accounted for when comparisons are made to third party comparables, i.e. the profit margin is adjusted to account for such additional risks.

## Issue 5 – The need for tax administrations to have access to all information needed to apply or review the application of a transactional profit method

***DESCRIPTION:*** *One practical difficulty encountered by tax administrations when reviewing a transactional profit method used by a taxpayer or when applying a transactional profit method in the course of an examination is the need to have access to information. There are different types of issues:*

- *The need to obtain information of an analytical or managerial nature that goes beyond the classical legal requirements (for instance, information from cost accounting systems),*

- *The need to obtain information on a foreign related party where the extent of the functions, risks and assets of the foreign party would have affected the compensation of the transaction under examination, should said transaction have taken place between independents,*

- *The need to obtain information on a foreign related party where the transfer pricing method applied necessitates information on the foreign party's functions, assets and risks (e.g. where a transactional net margin method is applied to the foreign party, or in the case of a profit split where both detailed financial information on the taxpayer and detailed financial information on the foreign related parties are needed).*

*Comments are invited on the extent to which these issues can be satisfactorily addressed in transfer pricing documentation requirements.*

**Comments**

***Access to Information Concerns***

Although it is undeniable that tax administrations do need access to information that may aid them to verify the application of transactional profit methods, such access is already provided by local legislation in many tax jurisdictions. Therefore, the additional advantage of addressing them in the OECD Guidelines is not very clear. In addition, from a practical standpoint, incorporating provisions that may potentially guarantee or require taxpayers to provide foreign information to tax administrators might in fact increase the already onerous transfer pricing compliance burden on taxpayers. Finally, from a legal standpoint, addressing these issues in the Guidelines will only increase confusion as to what is expected from taxpayers in terms of providing this information to tax administrations. Given that the OECD Guidelines do not have the force of law, a big concern is how tax administrations could potentially interpret any provision for access to information in the OECD Guidelines in a tax administration that does not have explicit local legislation on access to foreign information.

Given the potential legal morass that could potentially result from addressing such issues in the OECD Guidelines, it would be more prudent to refrain from any such endeavour. Every transfer pricing case is unique and it should be left up to the respective tax administrations and taxpayers to negotiate the kind of information that is necessary to reasonably verify the transfer pricing arrangements of an entity under audit taking into account the local legislation in the respective tax jurisdictions.

## Issue 6 – Application of a profit split method: determination of the profit to be split.

***DESCRIPTION:*** *There is currently limited guidance in the 1995 TP Guidelines on how to determine the profit to be split under a profit split method. Paragraph 3.17 indicates that "[g]enerally, the profit to be combined and divided under the contribution analysis is operating profit. […] However, occasionally, it may be appropriate to carry out a split of gross profits and then deduct the expenses incurred in or attributable to each relevant enterprise (and excluding expenses taken into account in computing gross profits)."*

*Comments are invited on the following issues:*

- *What measure of profit can be used in the absence of harmonised tax accounting standards? Can the profit to be split be determined according to financial accounting?*

- *In what cases should net, operating or gross profits be used in a transactional profit split method?*

- *Where a net margin is used, how is it defined? What are the expenses that should be treated as above or below the line? Does the response to this question differ depending on the functional analysis of the parties, e.g. on which party is responsible for what costs?*

- *Where operating profits are used, how to ensure that both income and expenses are attributed to the relevant associated enterprise on a consistent basis? How to identify the appropriate operating expenses associated with the transactions and to allocate costs between the controlled transactions under review and the associated enterprises' other activities?*

- *Where gross profits are used, how to ensure that the expenses incurred in or attributable to each enterprise are consistent with the activities and risks undertaken there, and that the allocation of gross profits is likewise consistent with the placement of activities and risks?*

**<u>Comments</u>**

***Determination of Profit to be split***

The most difficult exercise involving the application of the profit split method is generally the determination of the profit to be split. From a practical experience standpoint, in the absence of harmonized tax accounting standards and for that matter, financial accounting standards across the OECD countries, the decision on the appropriate measure of profit is rather important. In this context, the use of gross profits is generally less preferable mainly due to the fact that companies operating in different tax jurisdictions calculate gross profits differently whether it is for tax accounting or financial reporting purposes. On the other hand, operating profits generally do not suffer from the same limitation especially if one were to define precisely what an operating profit might be for transfer pricing purposes. In other words, a measure of operating profits is generally not as drastically affected by account classifications issues as a measure of gross profit.

However, if operating profits are used, it is imperative that the operating expenses be classified appropriately and consistently. In this regard, it may be prudent to include some guidance in the OECD guidelines as to how to identify operating expenses for the purposes of applying the profit split method using a measure of operating profits. In this context, perhaps the best way to approach this issue would be to define a consistent cost allocation methodology that is based on the functions performed and risks assumed in relation to a particular transaction. Such a cost allocation might involve the use of certain cost drivers to allocate costs on a consistent basis as is recommended for instance when pricing intragroup services transactions.

## Issue 7 – Application of a profit split method: reliability of a residual analysis and of a contribution analysis

***DESCRIPTION:*** *The 1995 TP Guidelines recognise that, when applying a transaction profit split method, there are a number of approaches for estimating the division of profits, based on either projected or actual profits, as may be appropriate, that independent enterprises would have expected. Two of these possible approaches -- contribution analysis and residual analysis -- are discussed in Chapter III of the 1995 TP Guidelines.*

*Comments are invited on:*

- *Whether there are cases where a residual analysis is more reliable or appropriate than a contribution analysis and if so why*

- *Whether there are cases where a contribution analysis is more reliable or appropriate than a residual analysis and if so why.*

- *Whether other types of approaches should be considered and if so in what cases and how they would apply.*

**Comments**

***Contribution Analysis***

From a theoretical perspective, application of a profit split method using a contribution analysis might seem to be an elegant solution to the problem of determining how to split profits between two enterprises that are involved in a controlled transaction that also involve the sharing of intangibles. By focusing on the relative contribution of the entities involved a contribution analysis does sound intuitively appealing.

However, from a practical standpoint, the contribution analysis exercise is one that is fraught with problems. First, identifying and accounting for relative contribution is rather difficult when shared intangibles are involved. Next, the determination of relative contributions may not always accurately capture the value of the intangibles created. For example, although two entities in a controlled transaction may be contributing to the development of an intangible, their relative contributions may not accurately reflect the intangible value that is created by their respective contributions. In such cases, merely looking at relative contributions may be misleading.

***Residual Analysis***

On the other hand, a residual analysis has the advantage that the contribution of the related entities involved in a controlled transaction is evaluated in two distinct steps. In the first step, the routine functions and risks undertaken by the entities are evaluated and the profit margins attributable to these routine functions and risks are clearly determined. In many cases, such routine margins can be determined by reference to third party comparables and as such, may lend themselves better to practical application. The second step involves the splitting of the residual profit, i.e. the profit that is left behind after the routine profits attributable to the entities have been identified, between the related entities. In essence, once the routine profits have been identified, it is clear that the residual profit is attributable to the intangibles shared between the entities. Therefore, the complexity of the exercise and the margin of error are considerably reduced since it is only the residual profit that needs to be split between the entities. Although one has to still examine the functions performed and risks assumed by the related entities as they pertain to the development of the shared intangibles, this exercise is much easier once the routine contributions have been clearly accounted for.

## Issue 8 – Application of a profit split method: how to split the profit

***DESCRIPTION:*** *Once the profit to be split is identified, a profit split method seeks to split the profit between the associated enterprises on an economically valid basis that approximate the division of profits that would have been anticipated and reflected in an agreement made at arm's length. The allocation of profit is based on the division of functions between the associated enterprises. External data from independent enterprises are relevant in the profit split analysis primarily to assess the value of the contributions that each associated enterprise makes to the transactions, and not to determine directly the division of profit. (See paragraphs 3.5 and 3.6 of the 1995 TP Guidelines).*

*As acknowledged at paragraph 3.18 of the 1995 TP Guidelines with respect to the contribution analysis, "[i]t can be difficult to determine the relative value of the contribution that each of the related participants makes to the controlled transactions, and the approach will often depend on the facts and circumstances of each case. The determination might be made by comparing the nature and degree of each party's contribution of differing types (for example, provision of services, development expenses incurred, capital invested) and assigning a percentage based upon the relative comparison and external market data."*

*Comments are invited on:*

- *The relevance in practice of external data to support the division of profits under a profit split method,*
- *How external data are used in profit split analysis and how they enhance the reliability and objectivity of the analysis,*
- *The reliability and objectivity of a profit split analysis that does not rely at all on external data,*
- *How to determine the relative value of each party's contribution to the controlled transaction under review,*

- *What allocation keys are mainly found in practice, in what cases are they suitable and what their strengths and weaknesses are,*

- *Whether different allocation keys should be used depending on whether the result to be split is a profit or a loss and if so for what reason(s).*

**Comments**

***Relevance of External Data when applying Profit Split Methods***

When applying the profit split method, one of the most important aspects of the exercise is the methodology used to split the profit between the related entities who are involved in a controlled transaction. Such a methodology has to be defendable in the face of extensive transfer pricing scrutiny by tax administrations and an improper application has have dramatic tax implications for the multinational taxpayer. Therefore, given that the fundamental objective underlying the application of any transfer pricing method is to prove the arm's length nature of a controlled transaction, any external third party data that is used to substantiate the profit split allocation methodology can be quite valuable. Therefore, there is little doubt that using external data to support the division of profits under a profit split method is relevant.

***Reliability and Objectivity Concerns***

Nonetheless, the question of whether external data do enhance the reliability and objectivity of the analysis does need to be examined further. The primary strength of external data is that they do indicate some element of objectivity in the analyses since such a comparison may be the best way to demonstrate that two related parties have transacted at arm's length. Still, although such third party comparisons may lay claim to objectivity, reliability of the analysis is not automatically guaranteed. In fact, the reliability of a profit split analysis that relies on external data depends crucially on the quality of the data and how it is used in the context of a transfer pricing analysis.

Therefore, one cannot necessarily assume that external data guarantees both objectivity and reliability in a profit split analysis. In the same vein, one cannot dismiss a profit split analysis that does not rely on external data to be not objective and unreliable.

***Allocation Keys***

Ultimately, the reliability of a profit split method application is crucially dependent on the economic rationale underlying the selection of the cost allocation keys employed in the analysis. In this context, the obvious cost allocation keys that could be potentially used in a profit split analysis might include incremental sales generated, employees involved or time spent. In practice, the best cost allocation key is one that bears a strong correlation to the intangible value that is being generated. For instance, one may find that employing incremental sales a key does not accurately reflect the relative contribution of the related parties in a profit split analysis. Instead, time spent on the development process may be a better indicator. The choice of the cost allocation key should ultimately be based on sound economic rationale which is backed up by a strong correlation between cause and effect, i.e. the key should be one that most accurately reflects the cause underlying the creation of intangible value that in the context of a controlled transaction.

## 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)?*

**<u>Comments</u>**

***Lower Comparability Standard for transactional net margin method vis-à-vis traditional methods***

The first issue, that of the acceptability of a lower comparability standard for the application of the transactional net margin method vis-à-vis a traditional method is a function of the fact that the transactional net margin method is more of an indirect method of demonstrating the arm's length nature of a transaction. For example, in the case of a traditional method, the comparability standards are necessarily higher since prices or margins on same/similar products are being compared with third party situations. On the other hand, given that the transactional net margin method is a profit-based method that uses aggregate level data, a one-to-one product based comparison is less relevant. Instead of such product comparisons, it is functional similarity that has to be scrutinized since functional similarity implicitly assumes that the parties being compared are performing similar functions. This is generally done by a detailed functional and risk analysis exercise and does serve to differentiate between say an entity that performs distribution functions vis-à-vis another that performs manufacturing functions. In essence, a lower comparability standard is acceptable for the application of the transactional net margin method since it is aggregate data that is being examined and functional similarity is more relevant when such data are examined rather than product similarity.

***Net Margins application using company-wide aggregated data***

In an ideal world, one would expect to compare net margins on a transactional basis rather than use company-wide aggregated data for both a taxpayer as well as third party comparables. This, however, is practically impossible in many cases since third party data is generally not available on a transactional basis or if available, the reliability of the transactional margins are in question. Therefore, one has to necessarily settle for lower comparability standards in this respect.

When it comes to taxpayer's net margins, it may be reasonable to expect an examination of net margins on a transactional basis especially if a taxpayers' financial accounting systems are able to track profitability on a product line basis and further differentiate between related party and third party margins. This, however, is ultimately a function of the sophistication of the financial accounting systems of a taxpayer and many taxpayers do not necessarily have the level of sophistication in their systems to identify transactional net margins rather than company-wide margins. However, even when such net margins are identified on a taxpayer's financial systems, the taxpayer often has to resort to comparing transactional net margins with third party net margins that are only reported on a company-wide basis.

## Issue 10 – Application of a transactional net margin method: determination of the net margin

***DESCRIPTION:*** *As indicated at paragraphs 3.26 and 3.27 of the 1995 TP Guidelines, the transactional net margin method examines the net profit margin relative to an appropriate base (e.g. costs, sales, assets) that a taxpayer realises from a controlled transaction (or transactions that are appropriate to aggregate under the principles of Chapter I). Net margins can be for instance return on assets, operating income to sales, and possibly other measures of net profits.*

*Comments are invited on how to select a net margin indicator to apply the transactional net margin, in particular:*

- *What is a "net" margin: what are the expenses that should be treated as above or below the line? Does the response to this question differ depending on the functional analysis of the parties, e.g. on which party is responsible for what costs?*

- *In what cases should the net margin be weighted against costs, sales, assets, or another base?*

- *Where the indicator is the net margin to costs, what costs should be included in the base? In what cases would a net margin to costs be more reliable or more appropriate than a gross cost plus indicator and why?*

- *How to ensure that the costs and expenses deducted from the net margin calculation are those attributable to the transaction under review?*

- *In what cases would a net margin to sales be more reliable or more appropriate than a gross resale minus indicator and why?*

- *Where the indicator is a net margin to assets, how should tangible and intangible assets be valued (market value or book value)?*

- *What other net margin indicators do you consider as relevant and in what cases?*

## Comments

### *Calculating Net Margins for Transfer Pricing Purposes*

Net margins are generally understood to mean the margins calculated after the Cost of Goods Sold and Operating Expenses are taken into account. In practice, for transfer pricing purposes, most practitioners and/or taxpayers exclude the following accounts:

- Interest payments and receipts
- Income taxes
- One-time impacts such as restructuring charges
- Foreign exchange gains and losses unrelated to operations (i.e. hedging gains/losses),
- Extraordinary or Unusual items
- Any other expense or income that is unrelated to the day-to-day operations of an entity

Generally, this answer is pretty consistent no matter which entity is being examined for transfer pricing purposes, however, they may be instances when additional expenses may be included or excluded depending on the situation at hand.

### *Selection of an Appropriate Base*

The general rule underlying the selection of the base for net margins is that the base used should not be part of the controlled transaction. For instance, when analysing a distributor, one would use Sales as a base since it is COGS that is controlled, i.e. the COGS for a distributor contains the cost of the goods that are purchased from the related party. In a similar vein, for a service provider one would not use Sales but the Costs of Service Provision since Sales is the controlled base.

Regards using Assets as a base, an important issue that needs to be considered is how assets are defined, i.e. whether it they include just current assets or fixed assets etc and exclude say intangible assets. In addition, assets can be quite valuable when evaluating manufacturing entities since they generally employ significant assets in their operations. On the other hand, they may be of less relevance in the case of service providers who do not employ significant fixed assets to render services to their related parties. In general, however, assets are a reliable base in many situations mainly because of the fact that balance sheet accounts are less susceptible to wide fluctuations during an analysis period.

### *Net Margin to Costs*

Generally, the net margin to costs profit indicator is used to test service providers. Consequently, the costs that should be included should ideally be all the costs of service provision including product and personnel costs that are incurred to ensure that the services are rendered. In almost all instances, the net margin to costs is more appropriate to use rather than a gross profit to costs mainly because of the lack of consistency in cost classification. This problem becomes especially acute when third party comparisons are involved since different third party service providers within the same tax jurisdiction may include different costs above the gross profit line.

In general, the only practical way to ensure that the costs and expenses included in the calculation of the net margin calculation is a detailed review of the cost accounts to ensure that there is a direct or indirect correlation between the costs incurred and the services that are rendered.

***Net Margin to Sales***

As indicated above, when there is inconsistency between how costs and expenses are classified above and below the gross profit line, it is best to use net margins rather than gross margins. This is especially pertinent when a transfer pricing analysis involves the examination of third party comparables who report their results using a different financial accounting standard than the one the taxpayer reports in.

***Net Margin to Assets***

When the profit indicator is net margin to assets, as indicated previously, one of the crucial issues is the identification of the assets that should be used. An equally important issue is how assets should be valued for transfer pricing purposes. While there is no definitive answer as to whether the book values or market values of the assets should be used, it is imperative to ensure that there is consistency in how taxpayer assets are treated in relation to third party comparable. For example, if the taxpayer chooses to use book values then adequate due diligence has to be undertaken to ensure that the third party comparables' asset values are also based on book values. Although there is some merit to using market values for assets since they capture the value of the assets better, book values are generally more readily available.

***Issue 11 – Other methods***

*Paragraph 1.68 of the 1995 TP Guidelines indicates that multinational enterprises "retain the freedom to apply methods not described in this Report to establish prices provided those prices satisfy the arm's length principle in accordance with these Guidelines". Commentators are invited to indicate what type of other methods not described in the Guidelines might be used in practice and for what reasons.*

*According to existing guidance in Chapter III of the 1995 TP Guidelines "[t]he only profit methods that satisfy the arm's length principle are those that are consistent with the profit split method or the transactional net margin method as described in these Guidelines. In particular, so-called "comparable profits methods" or "modified cost plus/resale price methods" are acceptable only to the extent that they are consistent with these Guidelines." (see paragraph 3.1 of the Guidelines). In addition the same Chapter contains an explicit rejection of global formulary apportionment as a non arm's length method (see paragraphs 3.58 to 3.74 of the Guidelines). Comments are invited on the practical and theoretical differences between the OECD transactional profit methods and other methods that are regarded as not arm's length.*

**Comments**

The use of these "other methods," while sanctioned by the OECD Guidelines, generally has not received favourable treatment by most tax administrations. This may be in part because of inherent ambiguity that the use of these other methods implies. In addition, taxpayers who use these other methods have to have an economically sound rationale for doing so and almost all instances, this implies additional compliance related work that most taxpayers are inclined to avoid. Nonetheless, a variety of the so-called hybrid methods have been used by taxpayers to defend their transfer prices.

From a practical standpoint, while it is good to retain an element of flexibility to use methods other than the ones addressed in the Guidelines, one has to very careful in applying them and using them as the primary method to defend transfer prices. In some cases, these other methods may be justified by the fact that a specific tax administration has approved their use, i.e. the comparable profits method, which is one of the methods approved by the Internal Revenue Service. In other cases, there may be a strong economic rationale to using them. In all cases, however, it should be remembered that the ultimate objective of using such methods is to prove the arm’s length nature of a related party transaction. If proof of arm’s length transactions is unequivocally accepted as the ultimate objective of a transfer pricing analysis, then methods such as global formulary apportionment, notwithstanding their practical feasibility and theoretical appeal, do not necessarily meet the standard.

That said the question remains whether multinationals should be expected to have arm’s length dealings at all times under all circumstances. In some ways, this expectation may run counter to the fact that the competitive advantage of a multinational is derived from the fact that they are able to take advantage of their international network and the efficiencies such a network might confer, including the ability to set competitive prices that need not necessarily always be at arm’s length.

## Conclusions

The invitation to comment on transactional profit methods that has been extended by OECD’s Working Party No. 6 does provide an excellent avenue for practitioners and taxpayers to comment on the practical realities of preparing transfer pricing documentation. This is a step in the right direction especially since such consultations do provide an excellent avenue to reflect collectively on the deficiencies in the Guidelines as they exist and how such deficiencies may be improved. The eleven issues raised by the OECD are very important not only because they represent a tangible attempt to grapple at the difficulties of the application of the transfer pricing methods but also to revisit the application of the sanctioned transfer pricing methods in their entirety.

Indeed, practitioners and taxpayers should take advantage of this excellent opportunity to engage the OECD issues so that any revisions of Chapter III of the Guidelines will adequately encompass and address the concerns of as many taxpayers as possible. After all, it is in the best interest of every taxpayer that the OECD Guidelines reflect the practical concerns of as many transfer pricing professionals as possible.