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INVITATION TO COMMENT ON TRANSACTIONAL PROFIT METHODS

CONTRIBUTION OF CMS ALLIANCE

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CENTRE FOR TAX POLICY AND ADMINISTRATION

INVITATION TO COMMENT ON TRANSACTIONAL PROFIT METHODS

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LIST OF ISSUES FOR CONSIDERATION

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.

CMS Alliance: We believe this is an important issue. As overall, preliminary remarks, we believe that several points should be stressed out:

- First, in applying the 1995 TP Guidelines, taxpayers, practitioners and tax administrations have often developed a concept, that, although not explicitly mentioned in the Guidelines as they currently stand, is in our opinion at the core of an appropriate functional analysis conducted based on these Guidelines: the notion of Entrepreneur within a business organisation. It is not the purpose here to comment on the content of the Guidelines as regards the comparability analysis or the functional analysis, nor on how they could be enhanced in respect of these elements, but the notion of Entrepreneur is, in our opinion, often a key to determining the choice of a method. In summary, the Entrepreneur may be defined as being, within the context of a transaction between related parties, the entity which conducts the most critical functions, bears the most important risks and/or develops the most significant intangibles used in the transaction and, as a results, which roles and responsibilities can be qualified as the most critical ones for value creation within the context of this transaction. As we will develop further below (see for instance comments on issue 4), we believe that, most often, the choice of a method (be it a traditional transaction method, or a transactional profit method), should be performed based on an understanding of what entity is the Entrepreneur for the analysed transaction.

- Second, in our experience, the practice that has emerged since a number of years is that, in many circumstances, the distinction between some of the traditional methods (namely, the Cost-Plus method and the Resale-Minus method) and one of the transactional profits methods (namely, the Transactional Net Margin Method, or "TNMM") is not very clear. These three methods have a lot in common. For instance, these three are the only methods presented in the Guidelines, that aim at setting the margin (gross or net) of only one of the two parties in the transaction. Besides, the Cost-Plus and the Resale-Minus methods could even be regarded as special cases of application of the TNMM, by using the gross margin as the profitability factor in the latter. Similarly, as we will further develop below in our comments on issue 2, the Cost-Plus method and the Resale-Minus method are quite often found being applied with an underlying reference to, respectively, return on total operating costs and operating margin, as this makes their use often more reliable or robust than a direct comparison to gross margin only. Finally, in our practical experience, these three methods, with a direct or indirect reference to return on total operating costs or operating margin, represent probably a very vast majority of the choices of a method by taxpayers for determining or documenting their transfer prices, especially as regards tangible goods and services.

For these various reasons, it seems to us very difficult to maintain, *as a general principle*, that transactional profit methods should be last resort methods. A given method can, very often, only be regarded as a first or last resort choice only after proper consideration of the specific facts in the case at hand.

In some cases, the distinction between traditional transaction methods and transactional profit methods may even sometimes appear somewhat artificial, especially as regards the TNMM.

In our opinion, however, the case of the profit split method is probably different, due to the difficulties in applying it (see our comments further below), as well as to the fact that the circumstances in which it is obvious that this method is probably a good first choice, are less commonly found in practice.

- 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?

CMS Alliance: We believe that our answer would be the same, as regards the taxpayer, whether the method is selected for setting arm's length prices of future transactions or for presenting a test of the outcome of already completed transactions at year end, in a transfer pricing documentation.

However, our opinion is that, should the principle of last resort methods be dropped in future Guidelines, the OECD should be very careful in explicitly making it clear that this should not give an opportunity to tax administrations to unduly challenge the choice of a method made by the taxpayer, in order to use another method for building a tax adjustment. In our experience, we have encountered in several cases a tendency of some tax administrations to disregard (either implicitly or explicitly) the method selected by the taxpayer and use a transactional profit method, especially the profit split method, to build a tax adjustment. This is sometimes the case when the method selected by the taxpayer (Cost-Plus or Resale-Minus) results in setting the margin of the legal entity which is under audit in an arm's length way, albeit the fact that profits abroad are, by definition in these methods, not taken into account. In this case, the use by the tax administration of the profit split method seems to follow the tendency of tax administrations to consider that profits of the other party should be taken into account anyway. In those circumstances, taxpayers have often fought that approach in, amongst others, reminding that the profit split method is, so far, a last resort method only. Therefore, in any revision of the Guidelines, the OECD should, in our opinion, explicitly state that a tax administration should be allowed to use another method than the one originally selected by the taxpayer, in order to build a tax adjustment, only after having proven that the taxpayer's method was not appropriate to the case at hand and/or that the tax administration's method leads to more reliable results.

- 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.

CMS Alliance: It seems difficult to draw a list of industry / activities/ transactions where the use of transactional profit methods is particularly appropriate. However, an example of the above, as regards activities in conjunction with the use of the TNMM, relates to manufacturing activities or, more generally, industrial activities that need high levels of investments in fixed assets. In these cases, an independent party would often determine the attractiveness of a given transaction by reference to its own objective of return on investment (which may take the form of various ratios such as return on assets, return on capital employed, etc). A transfer pricing method that would, in this framework, be built by reference to what return on investment may be observed for independent parties conducting a comparable activity, would therefore seem appropriate, which the TNMM would allow.

Another example, as regards industry in conjunction with the use of the Profit Split method, relates to global trading activities in the financial industry, where that method is often encountered in practice.

As regards business models, we believe that situations where the Entrepreneur qualification (see above) is shared between the parties (co-entrepreneurship situations) are those where the use of the profit split method seems appropriate. The same could apply to high risks or high margins situations where the business model of the taxpayer shows that both of the parties in the transaction contribute to a significant amount to the actual value creation process.

- 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.

CMS Alliance: The Profit Split method is, precisely, the only method presented in the Guidelines, that may be implemented in absence of comparable transactions between independent parties, by implementing it in reference to an internal analysis of the relative contribution of the related parties, in the framework of the analysed transaction. However, this needs that the functional analysis is performed in a way that allows for understanding the relative weight of each function and or risks, compared to the others, in order to appropriately measure the relative contribution of the parties. In our experience, this is more reliably achieved by an analysis of the business processes that exist within the organisation, in a dynamic way, than a mere analysis of separate functions and risks.

Besides, our experience is that, in practice, comparable data on gross margins is not commonly available, or, when it is, it is not reliable due to a number of reasons such as sensitivity of gross margins to volumes, functions and accounting principles. In practice, this makes a direct use of the Cost-Plus and Resale-Minus methods quite difficult to implement, most of the time. This is why these two methods are quite often implemented in a modified way (see some comments further below regarding issue 2, as well as issue 11), by reference to comparable data obtained on operating margins or return on total costs. In this context, the use of the Cost-Plus or Resale-Minus methods is therefore very close to that of a transactional profit method (the TNMM) since, precisely, the purpose of this approach is to render the use of the Cost-Plus and Resale-Minus methods more reliable.

- Any other remark you may have in relation to the hierarchy of methods in the 1995 TP Guidelines.

CMS Alliance: The CUP method is, in various instances in the Guidelines, presented as the method which should be favoured when it can be applied. In practice, precisely, our experience is that the CUP is only very rarely used (except in the case of intangibles where, by default and due to the difficulty to apply other methods, its use is more often encountered).

This is maybe one of the major examples of a significant departure of the standard practice of taxpayers and tax administrations, as it emerged throughout the years, from the current letter of the Guidelines.

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.

CMS Alliance: We believe that this is an important issue.

Preliminary comment: As practitioners, we strongly support the fact that the 1995 TP Guidelines *do not* require the application of more than one method. Any change that a future revision of the Guidelines might implement, and that would lead to either *require* the use of more than one method, or allow tax administrations to use different (and/or more) method(s) than that(those) that was(were) originally selected by the taxpayer itself, would lead in our opinion to too high a burden and too much uncertainty, from the perspective of the taxpayer, to be a reasonable equilibrium, provided that the method(s) that the taxpayer originally selected is(are) appropriate given the case at hand. Indeed, provided that the method originally chosen by the taxpayer is appropriate in its principle, given the case at hand (and in the light of the principles described in the Guidelines), any tax audit should focus on the quantitative outcome of that method, rather than on the outcome that would derive from the use of a different (or supplementary) method. It is our practical experience that, given the same set of facts, and even if in theory their outcome should be aligned, in practice, the use of two different methods will lead to two different quantitative outcomes: after all, as the Guidelines themselves state (§1.12), "transfer pricing is not an exact science". Therefore, enabling tax administrations to use other method(s) than the one(s) appropriately used originally by the taxpayer, would *de facto* enable tax administrations to build tax adjustments even when taxpayers have in good faith and in an appropriate way set their transfer prices according to the arm's length principle: if allowed by a revised version of the Guidelines, tax administrations would indeed merely have to use a method with a more favourable quantitative outcome from their perspective, to build such an adjustment.

This said, the Guidelines could more clearly allow for the use of more than one method, when this choice is originally made by the taxpayer itself in seeking as robust as possible the setting of its transfer pricing system. This should therefore be an option that is offered to the taxpayer in the framework of designing its transfer pricing system, neither as an obligation, nor as an opportunity offered to tax administrations to "re-write" the analysis after the facts. The comments mentioned below are made in this perspective.

Profit split: Aside from situations of co-entrepreneurship (see comments above regarding issue 1), it is our opinion that the profit split method may sometimes be useful, in conjunction with a traditional method (or even with the TNMM method), when the primary method leads to an arm's length range of values or margins, which is the standard case for methods that use several comparable transactions as a benchmark of the conditions that prevail between independent parties. In that case the profit split method might be used as an additional method for determining a point to select within the arm's length range obtained from the primary method. In order to use it in such a context, as much care should be given on performing a functional analysis that enables such an approach as described in our more general comments on the profit split (see above our comments on issue 1, as well as on issue 8).

TNMM: As mentioned in our comments above on issue 1, measuring an arm's length range of gross margins is, in practice, most often a very difficult and even quite an unreliable exercise: either comparable data is not available, or it may not be used in a reliable way, due to sensitivity of gross margins to factors such as volume (for exactly the same set of facts and the same functions, the gross margin, in percentage, that an independent party would seek to obtain may be halved if the volume offered to that party is doubled), intensity of functions (the gross margin that an independent party will seek will not be the same if it is meant to cover, for instance, a given level of costs of marketing activities vs. twice that amount), and accounting standards (gross margin is very sensitive to classification of costs as costs of goods sold vs. other operating expenses). Due to the inability to reliably adjust for (or even measure) all of these factors, the use of Cost-Plus or Resale-Minus methods is not very often implemented using a direct comparison to a benchmark of gross margins. Instead, it is our experience that they are often implemented in "modified" ways. In the case of the Cost-Plus method, this will for instance be achieved by using a mark-up on total operating costs, instead of a mark-up on costs of goods sold (an approach often called "Net Cost-Plus"). In the case of the Resale-Minus method, this will for instance be achieved by implementing it in several steps: i) target a given level of operating margin for the analysed transaction, for the party to which the Resale-Minus method is applied, based on a benchmark of operating margins earned by independent enterprises in comparable circumstances; ii) determine, based on the financial data of that related party, what gross (i.e. resale) margin it should earn in order to achieve the target operating margin obtained above; iii) use the thus obtained gross (i.e. resale) margin to set transfer prices, by deducting this resale margin from the resale price. This approach, often called "Modified Resale-Minus" seems, in our opinion, in line with the current Guidelines as the latter state (§ 2.14): "*[T]he "resale price margin" represent[s] the amount out of which the reseller would seek to cover its selling and other operating expenses and, in the light of the* *functions performed (taking into account assets used and risks assumed), make an appropriate profit*." This approach is often implemented based on budget data, sometimes with year-end adjustments to ensure that the return on total costs (respectively operating margin) of the related party to which the Net Cost-Plus (respectively Modified Resale-Minus method) is applied stays within the arm's length range. In both of the illustrations mentioned above regarding the Cost-Plus and Resale-Minus methods, the underlying use of a reference to a profit level that is achieved after all operating costs are taken into consideration, follows the objective to use more readily available and more reliable data, since both a return on total costs and an operating margin are, in our experience, usually less affected by such factors as volume, intensity of functions or accounting standards as gross margins are. In both cases, it has the same resulting effect as if the TNMM method had been used, in conjunction with the Cost-Plus, respectively Resale-Minus, method. It is our opinion that the Guidelines should explicitly endorse these two approaches as acceptable, modified ways to implement the Cost-Plus, respectively Resale-Minus methods.

See also our comments on issue 11.

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,

CMS Alliance:

As the current Guidelines state (§6.14): "*Arm's length pricing for intangible property must take into account for the purposes of comparability the perspective of both the transferor of the property and the transferee. From the perspective of the transferor, the arm's length principle would examine the pricing at which a comparable independent enterprise would be willing to transfer the property. From the perspective of the transferee, a comparable independent enterprise may or may not be prepared to pay such a price, depending on the value and usefulness of the intangible property to the transferee in its business.*" In respect of the above, we believe that the use of transactional profit methods, sometimes in conjunction with other methods (for instance, the CUP method, or other methods such as Discounted Cash Flows, see issue 11), may be particularly useful.

TNMM: From the perspective of the transferee, to which the charge in the transaction (e.g. royalty) often corresponds to an additional operating expense, a measure of the level of arm's length net margin that an independent, comparable transferee would seek to obtain from the activity in the framework of which the royalty is paid, after such payment, may provide an useful indirect measure of the maximum level to which the royalty may be set further to the arm's length principle. Indeed, any level of royalty that would be lower than this maximum would probably be accepted by an independent party dealing at arm's length, since it would lead, from its own perspective, to a net margin that is at least equal to, of even greater than the level of net margin it would seek to obtain.

Profit Split: From the perspective of both the transferor and the transferee, this method may be useful in situations where an appropriate way to set an arm's length price for the transfer (e.g. license) of intangible property is achieved through models that attempt to replicated how independent parties dealing at arm's length would seek to share the profits that are derived from the use of said intangible property. As a side note, we believe that, if the Guidelines provide more comments on the use of the Profit Split in this framework, it would be very important that they more clearly confirm that, also in this case, the Profit Split method must rely to the facts that are specific to the case at hand, instead of merely allocating profits to the transferor and the transferee based on a general, predetermined rule that would be the same for all transactions in all circumstances (an approach we have sometimes encountered in tax adjustments made by some tax administrations).

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

CMS Alliance:

Profit Split: As mentioned on our comments on issue 1, we believe that the Profit Split method, when based on internal data, i.e. the functional analysis itself, requires that said functional analysis attempts as far as possible to capture the relative importance of various functions and/or risks within an organisation, in order to assess the relative contribution of the various involved parties to the overall value creation. In this framework, an analysis of dynamic processes within the organisation, instead of functions or risks taken in isolation, may be a very useful approach. Precisely, such a business process analysis will also allow for a more elaborate understanding of how intangible property is developed, maintained and used within the overall organisation as well as, more specifically, in the framework of the transaction at hand. This in turn will feed the analysis of the relative weight of various functions and various risks, insofar as they interact with the development, maintaining and/or used of said intangible property, especially when that property corresponds to a competitive advantage of the organisation itself (see also comments on issue 8). Thus used, the Profit Split method may therefore help taking into account the intangibles used in the controlled transaction.

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.

CMS Alliance:

As mentioned in a preliminary, general comment expressed when commenting on issue 1 (see above), we believe that the notion of risk is very closely linked to the notion of Entrepreneur within an organisation, and that the latter may not be addressed explicitly enough in the current version of the Guidelines.

In summary, the Entrepreneur may be defined as being, within the context of an organisation or controlled transaction, the entity which conducts the most critical functions, bears the most important risks and/or develops the most significant intangibles used in the transaction and, as a results, which roles and responsibilities can be qualified as the most critical ones for value creation within the context of this transaction. We believe that, most often, the choice of a method (be it a traditional transaction method, or a transactional profit method), should be performed based on an understanding of what entity is the

Entrepreneur for the analysed transaction. Since the bearing of risks is one of the key factors in determining what entity is the Entrepreneur, an appropriate use of this notion, especially when made in conjunction with a transactional profit method, would prove in our experience to be a very useful tool to appropriately take into consideration the risks associated in a controlled transaction.

For instance, when the functional analysis shows that the role of Entrepreneur is actually shared to a significant extent between the parties in the controlled transaction (co-entrepreneurship situation), the use of the Profit Split method may often prove to be the most reasonable approach to set an arm's length transfer price between these parties. If the functional analysis was itself implement in the dynamic way that we describe for instance in our comments to issues 3 and 8, it will provide an elaborate understanding of how risks crystallise for the organisation itself and the processes through which they are identified, managed and borne, enabling the Profit Split method to appropriately take these factors into consideration.

Even when the role of Entrepreneur is not shared but borne by only one party in the controlled transaction, this notion may prove to be a key to the choice of an appropriate method, since the latter should be consistent with this observed entrepreneurship pattern. Out of the five methods described in the Guidelines, three, namely the Cost-Plus method, the Resale-Minus method, and the TNMM method, set the margin (gross or net) of only one of the parties in the controlled transaction. Assuming that the CUP method cannot be applied (for instance due to lack of available comparable data) and that the Profit Split would not be appropriate, this means that any selected method will set the profits of only one party, and, as a consequence, that any major unexpected event (difference between forecasts and actual outcome, unexpected economic success or downturn, major change in the external economic environment, etc) will primarily impact the other party's profits. It seems obvious that this party should, precisely, be the Entrepreneur, as identified by the functional analysis. In other words, the method used (be it the TNMM of even a traditional method such as Cost-Plus or Resale-Minus) should set the margin of the party which *is not* the Entrepreneur in the controlled transaction.

Another example of how, in our opinion, risks should be taken into consideration, is the case of an activity which by itself creates a fairly significant element of risk, although it does not automatically make the entity conducting it the Entrepreneur in the transaction. Examples of this are manufacturing activities in an industrial framework where needed capital investments are significant. Because of the significance of said capital investments, such an activity creates risks for the party conducting it, although that party (manufacturer) is not necessarily the main Entrepreneur in the controlled transaction. In that case, the use of the TNMM, with a benchmark of the return on investment (expressed for instance through a ratio such as return on assets, return on capital employed, etc) that independent, comparable manufacturers would seek to achieve in comparable transactions, therefore integrates that kind of risk into the transfer pricing analysis, since the outcome of the TNMM shall, in this context, lead to a remuneration for the manufacturer that is proportionate to the risks it takes.

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),

CMS Alliance:

In our experience, this is not an issue that differentiates transactional profit methods from traditional methods. For instance, any use of a method such as the Cost-Plus method shall lead to the use of information derived from cost accounting systems, even when (and especially when) the Cost-Plus method relies on gross margin, which implies differentiating direct costs from indirect costs, which in many jurisdictions, is not a classical legal requirement. Actually, because all of the methods described in the Guidelines are, by nature, transactional, all of them potentially (and, quite often, effectively) imply needing to obtain information that goes beyond legal requirements, since it is usually not a legal requirement in all jurisdictions to determine profits (be they gross or net), on a transaction-by-transaction (or even product line by product line, or activity-by-activity) basis. In our experience, when confronted to a traditional method, for instance a Resale Minus method that would focus only on gross margin, tax administrations themselves, in the information requests that they express during tax audits, ask for information that is of analytical or managerial nature, such as, in the example given above, marketing costs attached to a given product line, or segmenting the Profit & Loss statement between related-party vs. unrelated-party transactions.

Therefore, in our opinion, the difficulty that the OECD identifies above should not, in practice, provide enough justification to tax administrations to challenge the use that a taxpayer would make of a transactional profit method.

- 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,

CMS Alliance:

In our experience, this is again not an issue that differentiates transactional profit methods from traditional methods: in any controlled transaction, the extent of the functions, risks and assets of the foreign party does affect the compensation of the transaction under examination, notwithstanding what method (transactional profit method or otherwise) is used. This, in our opinion, is the very essence of the comparability analysis that the OECD has appropriately emphasised in the current Guidelines. Otherwise this would mean that the comparability analysis would not bear any effect on how transfer prices would be set at arm’s length. In our experience, the use of a transactional profit method does not usually make this any more difficult than the use of a traditional method. For instance, the use of a Resale Minus method applied to a foreign entity will not make the extent of the functions, risks and assets of that foreign party less important to the analysis than the use of the TNMM method. It is even sometimes the contrary.

Besides, information on a foreign related party as regards the extent of its functions, risks and assets, is inherent to the Functional Analysis section of a transfer pricing documentation. Any difficulty claimed by a tax administration in respect of that is equivalent to claiming that the information provided in said Functional Analysis section is not reliable (or cannot, as a principle, be regarded as reliable), which again is not correlated to what method is used.

- 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).

CMS Alliance:

In our experience, this is again not an issue that differentiates transactional profit methods from traditional methods: both as regards the Cost-Plus and Resale minus methods, on the one hand, and the TNMM and Profit Split methods, on the other hand, detailed financial information on the foreign related parties shall be needed for at least one of the two tax administrations across the border.

Only in the case of the Profit Split method does this issue become more intense, since in that case said issue shall arise from both sides of the border.

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

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?

CMS Alliance:

Although this issue appears to us to be an important one, we do not believe that a general answer, that would enable setting forth precise enough general principles, currently exists to the various questions listed above, precisely in the absence of harmonised tax accounting standards.

This is what has made the use of the Profit Split method relatively difficult to implement, so far, in cases where the profit to share cannot be determined using a single accounting referential. In absence of the above, we believe that the use of financial accounting may be a reasonable approach. In our experience, this would more often be performed at the level of operating profits (i.e. most often an equivalent to EBIT, earning before interest, taxes – and extraordinary – elements).

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.

CMS Alliance:

We believe that a residual approach may reliably be used when not all functions of the parties between which profits are shared correspond to the role of Entrepreneur (see above), or, in other words, when some of these functions are of a "routine" kind (as implied by the notion of "*basic return appropriate for the type of transactions in which [that party] is engaged*" developed in §3.19 of the Guidelines). However, even in this context, this does not mean that a contribution analysis might not be reliably achieved, provided that the functional analysis is conducted with the dynamic approach that we describe in our comments on issues 3 and 8 since, in that case, the relative weight of routine vs. non-routine functions will be appropriately taken into account in the contribution analysis.

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,

<u>CMS Alliance</u>:

In our experience, we do not know of cases where external (quantitative) data (i.e. direct information on how unrelated parties have actually split profits in transactions on the open market) could be used in a sufficiently reliable way.

- How external data are used in profit split analysis and how they enhance the reliability and objectivity of the analysis,

<u>CMS Alliance</u>:

In our experience, qualitative external data, especially as regards the trends in the taxpayer's industry, or the external analyses of the taxpayer's positioning and strategy, may feed an internal contribution analysis with appropriately objective elements to be taken into account when assessing the relative importance of various functions, risks assets, etc, in the framework of a contribution 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,

<u>CMS Alliance</u>:

In our experience, a possible approach that has been efficiently used in practice, may be as follows (highly summarised):

- Industry analysis: understand trends and forces in the taxpayer's industry (intensity of competition, bargaining power of suppliers, customers, barriers to entry, threats of substitution products), critical success factors (i.e. "must have" and/or "must do" items that any player in the industry must feature to be able to compete), potential sources of competitive advantages;

- Company analysis: in light of and in relation to the above, understand the company's overall competitive positioning, strengths, weaknesses, opportunities, threats, strategy, effective competitive advantages, core competencies;

- Process analysis: in light of and in relation to the above, understand the organisation's business processes, their purpose, inputs, outputs, the resources they create and/or use (e.g. intangibles), the risks that they enable to manage and/or that they generate, how they enable the company to develop, maintain and/or enhance its competitive advantages and/or core competencies, and how they fit into the company's strategy; based on this, assess the relative weight of the various business processes;

- Contribution analysis: in light of and in relation to the above, understand the contribution to the business processes of the various legal entities involved in the transaction, qualify this contribution (complex vs. simple, intensive vs. limited, design/decide vs. control vs. execute, etc), qualify the roles and responsibilities of the various entities (cost centres, expense centres, revenue centres, profit centres, investment centres, etc); based on this, assess the relative contribution of the entities to each process, in a quantitative way; combine this with the relative weight of the processes (see process analysis) to obtain an assessment of the relative contribution of each related party to the company's overall value creation.

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

CMS Alliance:

In practice, keys relating to costs (total industrial costs, for instance) or headcount (specific types of employees with critical roles, for instance) are often encountered in our experience.

- 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).

CMS Alliance:

We believe that this question would have to be addressed on a case-by-case basis although, as a general rule, it could be argued that the key could stay the same, *if* the Profit Split method is used in a situation of co-entrepreneurship, in order to achieve a sufficient symmetry of risk-bearing between the parties.

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)?

<u>CMS Alliance</u>:

As regards resemblance of the TNMM to the Cost-Plus and Resale Minus methods, see our comments above, especially as regards issues 1 and 2, as well as issue 11.

As regards comparability criteria such as volume, accounting standards and intensity of functions, see our comments regarding issue 2: It is our opinion that the use of an operating margin (or return on total operating costs, as well as some other ratios based on operating profit), instead of gross margin, makes the transfer pricing analysis a lot less sensitive to differences as regards these criteria. Since operating margin is computed after all operating costs (especially fixed costs) are covered, it is our practical experience that a difference in volume (e.g. total sales amount) bears only a very limited impact on the observed operating margin in many industries and in many cases; again, since the analysis is performed after all operating costs are covered, intensity of functions (for example, determining whether a distributor invests x% of its sales in marketing activities, or twice that amount) can be observed to bear very little impact as well in many cases, in our experience; finally, since the operating margin is by definition not affected by differences of classification of costs in costs of goods sold vs. other operating expenses, it is therefore not impacted by one of the major sources of accounting differences between companies or between jurisdictions.

As regards nature of functions, we believe that the same level of comparability should in theory apply in using the TNMM as in using the Cost-Plus or Resale-Minus methods. However, in practice, it has to be reminded that the arm's length ranges obtained when a benchmark of operating margin is performed, are usually a lot more narrow than an arm's length range of gross margin may display: in our practical experience, the width of almost all ranges of gross margin are expressed in tens of percentage points (for instance, from 30% to 60%), whereas the width of a range of operating margin is almost always expressed in a few percentage points (for instance, from 2% to 5%). This is the reflect, amongst other, of the sensitivity of gross margin to many kinds of differences, especially differences in the nature of functions. This make, in our practical experience, the ranges of operating margin that are actually obtained when benchmarking different functions in the same industry and/or the same function in different industries, much closer to one another in reality than one would have assumed before performing the exercise. In practice, there is often a significant amount of overlap in said ranges. It is our opinion that this makes, *de facto* if not in theory, the use of operating margin somewhat less sensitive to differences in functions than the use of gross margins. Therefore, we believe that a similarity of functions, when significant enough, should usually be accepted as meeting an appropriate standard of comparability when applying the TNMM method.

- 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)?

CMS Alliance:

We understand that the TNMM method, in its current definition in the Guidelines, is a transactional method.

Therefore, we believe that aggregation standards for applying this method should be in line with the Guidelines, especially the general standard expressed in § 1.42.

This said, it is our opinion that an appropriate reference to said standard may, in many cases, validly lead to applying a transfer pricing method (e.g. the TNMM method) on company-wide data. This is for instance the case when the company that is analysed (either the related party in the controlled transaction, or an independent company that is used in a benchmark panel) conducts only one significant activity (for instance in the framework of using the TNMM for distribution transactions, the distribution of products that are comparable enough, with functions that are comparable enough). If the analysed company only conducts a single activity (or if it can be shown that any other activity it conducts is marginal in terms of sales or costs, for instance), and if the comparability criteria are met on a company-wide basis, one can, in our opinion, reasonably argue that its company-wide financial statements are the reflect of a sum of transactions that are all comparable enough to the controlled transaction, which makes a company-wide approach fully valid. Therefore, in summary we believe that, in this respect, one key element to the current issue is to ensure that such a company conducts only one significant activity.

In our opinion, company-wide approaches should therefore be accepted in a revised version of the Guidelines with, for major limits:

- The need to apply the TNMM on an activity-by-activity basis, if a given company conducts several different significant activities at once, which implies the need to use segmented accounts in that kind of situation, unless it can be shown that the results of a segmented analysis vs. a company-wide analysis would be equivalent (for instance, because the arm's length ranges of operating margins would be broadly the same for all activities);

- The need to apply, to the related party, the TNMM method only to controlled transactions, which again implies the use of segmented account in case the company conducts the same activity both in the framework of controlled and uncontrolled transactions, unless it can be shown (given the principles expressed in § 1.42) that all transactions (controlled and uncontrolled) are sufficiently closely linked together from an economic standpoint, so that a segmented analysis would not lead to a meaningful result.

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?

CMS Alliance:

Some examples are: return on total operating costs (operating profit divided by total operating costs) for services or manufacturing activities, operating margin (operating profit divided by net sales) for distribution activities, return on assets (operating profit divided by fixed assets) for manufacturing activities.

We would like to stress out the fact that the above are only examples, and should not be turned into standard rules, as we believe that each situation must be analysed on a case-by-case basis, and an appropriate ratio be selected accordingly.

- 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?

CMS Alliance:

See our comments on issues 1, 2 and 9, that address this point.

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

CMS Alliance:

See our comments on issue 9, that address the notion of aggregation and segmentation.

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

CMS Alliance:

See our comments on issues 1, 2 and 9, that address this point.

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

CMS Alliance:

Although we believe that this is an important issue, we believe that, for practical reasons, the Guidelines should accept (but not necessarily impose) that the analysis use book value of assets, since otherwise the Guidelines would make such an analysis either impractical or too uncertain or burdensome both for taxpayers and tax administrations. With the growing introduction of IFRS accounting standards in many jurisdictions, we believe that, in the future, this issue will be of less importance anyway. Finally, we believe that, again for practical reasons, intangible assets should usually be excluded from the assets used in computing the ratio, since this kind of assets is usually the one for which discrepancy between book vs. market value may be highest.

We would like to stress out the fact that the above are only examples, and should not be turned into standard rules, as we believe that each situation must be analysed on a case-by-case basis, and an appropriate approach be selected accordingly.

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

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.

CMS Alliance:

In our experience, the Discounted Cash Flows ("DCF") method is often used for certain types of transactions, especially regarding intangible property, or in situations where assets are transferred from on related enterprise to another. In general, it is one of the most commonly used method applied by financial analysts and practitioners for the valuation of assets, businesses or companies.

In the case of transactions regarding intangible property (license or transfer), this method proves to be very useful to address the perspective of the transferor, as required by § 6.14 of the Guidelines, as it may for instance enable to determine what royalty flows the licensor would expect, based on the cash flows it would otherwise obtain for a direct use of the licensed intangible, which to this party is an alternative to the contemplated controlled transaction (taking into account differences in risks attached to these two options, which may properly be reflected in differentiated discount rates). Other examples of the use of this method could be developed.

In our opinion, the current Guidelines already provide some hints that the use of the DCF method may be appropriate since, again as regards intangibles, § 6.20 states: "*In applying the arm's length principle to controlled transactions involving intangible property, some special factors relevant to comparability between* *the controlled and uncontrolled transactions should be considered. These factors include the expected benefits from the intangible property (possibly determined through a net present value calculation)*", and since the very purpose of the DCF method is precisely to assess the net present value of future cash flows (i.e. expected benefits from a financial standpoint).

We believe that revised Guidelines could be more explicit in this regard, and provide more guidance on how this method could be used.

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.

CMS Alliance:

See our comments above as regards the modified cost-plus / resale price methods. We believe that, in many instances where these methods are used according to the summary description we provide in our comments, their use fully satisfies the arm's length principle. We would not suggest that the Guidelines should list these methods among the transactional profits methods (along but different from the profit split and TNMM methods), but that the Guidelines should acknowledge the use of these methods, which is our experience is becoming fairly generalised, as providing a very useful bridge between traditional methods and transactional profit methods. If necessary, the Guidelines could provide more guidance one the use of these methods.

We believe that the rejection of global formulary apportionment methods by the Guidelines should be maintained, as we believe that these methods do not satisfy the arm's length principle. As a general rule, we believe that methods that do not take into account the facts that pertain to the controlled transactions at hand should not be acceptable. We believe that a stronger emphasis on this criterion could be put by the Guidelines, on recognising a method as satisfying or not the arm's length principle.

Issue 12 – Other issues

Please feel free to comment on any other issue you may wish to raise in relation to transactional profit methods.