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OECD Invitation to Comment on Transactional Profit Methods

Throughout this document, “KPMG” [“we,” “our,” and “us”] refers to KPMG’s Global Transfer Pricing Services group. It does not refer to KPMG International, a Swiss cooperative. KPMG International provides no client services.

The OECD has requested comments on the use of transactional profit methods, including both the transactional profit split method (profit split) and the transactional net margin method (TNMM). This submission provides KPMG’s Global Transfer Pricing Services (KPMG) comments on the various questions presented in the OECD’s request.

The response begins with an overview that sets forth key points that KPMG believes should govern the transactional profit methods. This is followed by a more detailed response to the specific questions raised by the OECD. Three articles that have been referenced in footnotes have also been attached as they provide additional detail on certain points.

Key Points

KPMG would like to emphasize that the following general principles should govern the application of the transactional profit methods.

Status of Transactional profit methods as Methods of Last Resort: Multi-National Enterprises (“MNEs”) should be free to use the most appropriate method.¹ Therefore, the transactional profit methods should be given the same status as the traditional pricing methods. This is particularly true given the limited information and data available to taxpayers and tax authorities for use in performing transfer pricing -- in many cases the transactional profit methods are the most effective and reliable methods in assessing arm’s length prices.

¹ See OECD Guidelines, 1.68.

Business Structure and Risk: The application of the transactional profit methods is especially dependent upon the business structure and the allocation of risk used in evaluating the transactions. Different business structures and different allocations of risk may lead to different, but equally arm's length, prices. It is reasonable for tax authorities to expect taxpayers to provide a clear specification of business structure and risk. However, once this is done tax authorities should apply the transactional profit methods in a way that respects taxpayer decisions, provided that the allocation of functions and risks is consistent with the capabilities and practices of the parties.²

Losses: The OECD Guidelines should recognize that businesses in fact incur losses at arm's length. In some cases, these losses may be minor and transient, and made up by profits in other periods. In other cases, the losses may be substantial with no prospect of recovery in future years – if a satellite launch fails, the substantial investment made in building and launching the satellite is lost, and there is nothing that can be done to bring it back. Finally, businesses may incur losses for a number of years without shutting down for valid economic reasons that have nothing to do with transfer pricing – pension liabilities for retired workers in traditional steel companies; global overinvestment in excess capacity that can last for decades, the high cost of shutting down an operation due to local laws to protect labor and other interests in certain countries.

It has been KPMG's experience that some of the most difficult and intractable transfer pricing issues arise when both parties to a transaction incur losses and the tax authorities on both sides of the transaction make transfer pricing adjustments on the assumption that businesses always make a profit at arm's length. A risk bearing business may earn losses in the short to medium term even if the overall enterprise is profitable because of specific local market considerations or the materialization of other risks that leave the affiliate with losses. The OECD Guidelines should specifically disavow the notion that distributors should always be profitable or any strict rules that, for example, distributors must earn a profit after no more than three years of losses. Taxpayers should be able to demonstrate the existence of facts justifying the losses in all cases.

Annual Audits of Multi-Year Investments: Tax authorities necessarily audit specific tax years. However, a tax year is an arbitrarily defined period of time that often has little or no relationship with the period of time that is needed to evaluate the economic performance of a specific investment. Moreover, the various financial ratios used in the application of the transactional profit methods are often focused on specific periods of time and may differ from true measures of economic profits. The OECD Guidelines should recognize that this poses specific problems in the application of the transactional profit methods, and allow for flexibility in addressing the problems raised by this issue. The use of multi-year averages should generally be allowed.

² See OECD Guidelines, 1.36.

Documentation and Data Needs: Tax authorities should expect taxpayers to provide a clear explanation as to why their transfer prices are arm's length and to provide the data needed to evaluate the taxpayer's position. However, the development of required documentation can impose significant burdens on taxpayers, particularly given the recent proliferation of documentation requirements. Documentation requirements should be limited to the information that tax authorities need to make a reasonable assessment of the taxpayer's transfer pricing, taking into account that tax authorities can request additional information if more detail is needed on specific transactions.

Tax authorities should not ask for information that is not relevant to the evaluation of the transactions at issue. Asking for irrelevant information both imposes unnecessary compliance costs on MNEs and impedes the tax authority's evaluation of the specific transfer pricing transactions at issue. Finally, the level of documentation expected by tax authorities should be linked to the size of the transaction, both in nominal terms and relative to the taxpayer's business, and whether there is any indication that the transaction is unusual and requires special attention.

Fairness: Transactional profit methods should not be applied in a way that can be expected to produce systematically biased results. The OECD Guidelines should therefore affirmatively discourage the practice of some tax authorities to cherry pick, and apply transactional profit methods to make selective adjustments that will ultimately result in excessive profits for the legal entity that is being taxed in their jurisdiction.

Similarly, tax authorities should not evaluate transfer prices using data that are not available to the taxpayer. Taxpayers are limited to their own internal data and public sources of information. The use of secret comparables by tax authorities effectively means that taxpayers cannot have set their transfer prices in a way that would conform to the tax authority's expectations and severely limits the ability of taxpayers to ascertain the real basis of the adjustments levied by tax authorities.

Flexibility and Adaptation to Unusual Situations: It is impossible for any guidance or regulations to consider every possible fact pattern that may affect the selection of a pricing method or the detailed implementation of a pricing method. Moreover, there is often no precise set of data or computations that generates a single unique correct answer. MNEs should have flexibility in making *reasonable* economic choices in the application of all pricing methods, including transactional profit methods.

Issue 1: Status of Transactional Profit Methods as Last Resort Methods

Highlights

Taxpayers should be allowed to use any method that gives the most reliable result, and therefore the transactional profit methods should be accorded the same status as the traditional pricing methods. The use of transactional profit methods is especially appropriate in cases in which: (i) the data

needed to apply traditional pricing methods are not available; (ii) transactional profit methods are easier to apply than the traditional pricing methods but can be expected to give equally reliable answers; and (iii) there are closely related transactions that are most appropriately evaluated jointly.

Having said this, the transactional profit methods are based on the assumption that transfer prices are the primary determinant of profits. Therefore, they should not be used, or should be used with great care, if non-transfer pricing factors are a key determinant of the profits. The transactional profit methods should not be used as a way of forcing a particular profit result.

Finally, taxpayers should be free to use the transactional profit methods to test prices when the use of an OECD-consistent transfer pricing methods imposes an administrative burden or are inconsistent with an MNE's incentive structure. MNEs should be able to use transactional profit methods to set prices when this is needed to respect a specific allocation of risk or to evaluate transactions whose economics cannot be evaluated based on a single year's data.

Should Transactional Profit Methods be Methods of Last Resort?

While taxpayers with good transactional data should be able to use transactional methods without formally considering profit based methods, transactional profit methods should *not* be methods of last resort. Instead, taxpayers should be allowed to use the method that gives the most reliable results with a reasonable level of effort. Saying that a transactional profit method is a "method of last resort" suggests that the traditional transactional methods can be used even if a transactional profit method is more reliable. This does not serve the interests of either taxpayers or the tax authorities.

The recommended change in the status of the transactional profit methods would reflect current practice. Both taxpayers and tax authorities often use transactional profit methods. Available data regarding some of the OECD members' advance pricing arrangement and mutual agreement procedure programs indicate that transactional profit methods are possibly used more often than any other methods to resolve double tax issues.

Cases in Which Transactional Profit Methods Can be Useful

The use of transactional profit methods is especially appropriate in cases in which:

- The data needed to apply traditional pricing methods are not available
- Transactional profit methods are easier to apply than the traditional pricing methods and can be expected to give equally reliable answers
- There are closely related transactions that are most appropriately evaluated jointly.

This is not intended to be an exhaustive list, but to highlight some common situations in which the use of transactional profit methods is appropriate.

Data Availability

Transactional profit methods can be especially useful when the data needed to apply traditional transactional methods are not available. This is particularly true given the limited information and data available for use in performing transfer pricing analyses -- in many cases the data needed to apply the traditional transactional methods are either not available or are not reliable. For example, while the OECD Guidelines discuss the cost plus method in terms of gross cost plus markups, in most countries external comparables cannot be used as the statutory accounts that are publicly available do not distinguish between cost of sales and other costs. Often it is not a matter of whether a traditional method is better than a transactional profit method, as the traditional method cannot be applied at all.

Similarly, there are cases in which third party data are simply not available for unique intangibles or where each party to the transaction plays a unique role. Such situations occur, for example, when Affiliate A undertakes the investment needed to develop new product X and Affiliate B undertakes the investment needed to develop the manufacturing process for this product. Not only are there no pricing data for product X, but there are no third party transactions that will reflect the exact pattern of risk and investment undertaken by Affiliates A and B.

Transactional Profit Methods Are Easier to Apply

There are a number of cases in which transactional profit method are simpler to apply and are just as accurate as the use of a transactional method. Common examples of this include the use of the TNMM in determining the markup on low value services, the net markup for contract manufacturing, or the operating margin of a low risk distributor with no unique intangibles.

In some cases, transactional profit methods may be easier to apply (and audit), and give more accurate results, than a traditional transactional method even when the data needed to apply the latter are available. For example, gold is a commodity with a clearly defined price. It would therefore seem to be an ideal candidate to be priced using a CUP. However, the price of gold varies almost by the minute, and so the specific timing of the purchase has a major impact upon price. If Affiliate A is selling gold to Affiliate B, which is then selling it to a third party, with perhaps 100,000 separate transactions per year, it is likely to be very difficult for tax authorities to match the price charged in each of these 100,000 transactions with a market price prevailing at the exact time of the transaction. It may be much easier to simply determine whether Affiliate B should get a TNMM margin for its resale function. In other cases, transactional data may be available but reflect substantially different allocations of responsibilities and risks between the parties than the

controlled transaction; a TNMM analysis may be more reliable than any attempt to adjust the transactional data for these differences.

Associated Transactions

Transactional profit methods are also useful in cases in which two transactions are linked, and where it is difficult to find transactional comparables that reflect the impact of the linked transactions. This commonly occurs, for example, in “blades/razors” situations in which the sale of one product (the razor) depends upon sales of other products (blades). Such transactions are discussed in Issue 9.

Cases in Which the Use of Transactional Profit Methods Are Not Appropriate:

Unlike transactional methods, which use direct measures of prices or margins to evaluate intercompany pricing, transactional profit methods make inferences about prices from profits. The TNMM, for example, assumes that if the operating profits of the related entity being evaluated are consistent with the operating profits of comparable third party transactions, then the intercompany prices are arm’s length. However, the ability to make such inferences depends crucially upon the assumption that there is a close linkage between profits and transfer prices.

At a minimum, the effective application of transactional profit methods requires a focus on just those profits that are related to the transaction at issue, which may often require the use of segmented financial results.³ More generally, however, there are a number of cases in which a close linkage between profits and prices does not exist. As a simple example, take the case in which a parent company supplies a portion – say 10 percent – of the component parts used by a manufacturing affiliate. Under such circumstances, the profits of the manufacturing affiliate are likely to be much more dependent upon the prices paid to unrelated third parties for the remaining 90 percent of its component purchases than on the transfer prices paid to the parent company. Therefore, testing the financial results of the manufacturing affiliate using a TNMM is not appropriate.⁴ While this point appears obvious, KPMG is aware of a number of cases (especially in the U.S.) in which tax authorities have proposed adjustments that are well in excess of total intercompany purchases, therefore implying that the seller would pay the buyer to take product off of its hands. This is not a commercially reasonable result. Even in less extreme cases, the use of transactional profit methods under such circumstances can lead to situations in which the transfer prices determined under such methods fluctuate sharply (20 percent, 40 percent) from year to year for reasons that are unrelated to pricing.

³ See Issue 5.

⁴ It may be in this case that a TNMM with Parent Company would be appropriate if the profits of the Parent Company on such transactions can be reliably measured.

More generally, under the traditional pricing methods there is a clear distinction between pricing (e.g., prices are set using a third party CUP) and the impact of non-pricing factors (e.g., the taxpayer may earn high profits based on that CUP when capacity utilization is high, and suffer losses when capacity utilization is low). This distinction is much harder to preserve under the transactional profit methods as the measure that is being used to evaluate prices (the profits realized in the transaction) is effected by both pricing and non-pricing factors. For example, if a manufacturing affiliate constructs a plant that is capable of producing 100,000 units per year and market demand is such that only 10,000 units a year are needed, then the profit performance of the affiliate is likely to be determined much more by capacity utilization than by transfer prices. Or, in the case of intangibles, a parent company may develop intangibles that would command a positive price in the market but that are not a key driver of profits (e.g., a refinement to rolling mill control software). Under such circumstances, the use of a TNMM with the licensee as the tested party may attribute a higher or lower value to the intangible when other factors (e.g., an energy shortage, a sudden surge in market demand) may play a much more important role in the determination of operating profits.

The fact that the distinction is blurred does not imply that it does not exist, and should not allow tax authorities to make transfer pricing adjustments to “correct” for non-transfer pricing issues.⁵ The application of the transactional profit methods should respect the difference between the Parent Company’s role as an investor and its role as a supplier. Consider the following example. Parent Company manufactures television sets in Country A. It acquires Subsidiary in Country B. Subsidiary produces MP3 players.

For the next five years, Subsidiary continues to manufacture and sell MP3 players in Country B using its own technology, trademarks, sourcing and manufacturing. Parent Company derives no benefits from Subsidiary’s technology or other IP, and its only interest in Subsidiary is that of an investor. Under such circumstances, there are no intercompany transactions and there should be no transfer pricing issues. Moreover, this is true regardless of whether Subsidiary has five consecutive years of losses or five consecutive years of extraordinary profits.

In Year 6, Parent Company starts to source plastic casings for Subsidiary from one of its unrelated suppliers of such casings because it is able to procure these products at a lower price. Parent Company marks up the plastic casings that it buys for Subsidiary by 1 percent. The inter-company transfer prices cannot reasonably be valued at less than the price paid to the unrelated third party supplier. Moreover, this should be true regardless of Subsidiary’s profitability (or lack of profitability).

⁵ See Paragraphs 1.36-1.41 of the OECD Guidelines.

Use of Transactional Profit Methods for Setting Prices vs. Testing Prices⁶

While the OECD Guidelines strongly favor taxpayers determining whether their transfer pricing is appropriate before the actual pricing is established,⁷ taxpayers should be able to use transactional profit methods to either demonstrate that they have set prices in an arm's length manner or test whether the after-the-fact results generated by their transfer prices are consistent with arm's length expectations. The lack of information on how prices are set should not lead to any adverse inferences about the reliability of the transfer pricing.

Use of transactional profit methods to test ex post results

At arm's length, companies generally set prices ex ante, and transactional net margin methods should not be used to undermine this basic principle. However, the use of the specified methods may impose unnecessary administrative burdens on taxpayers or undermine an MNE's ability to set prices to meet specific management objectives. For example, in many cases in which a manufacturing affiliate sells to a distribution affiliate, the latter may be the simpler party, and the most appropriate method may be to use either a TNMM to compare the profits of the controlled distributor with that of the uncontrolled comparables. However, the MNE's accounting system may be such that it is much easier to set prices based on a markup on standard costs. Alternatively, MNE's with decentralized decision-making may set transfer prices based on negotiations among the various affiliates in order to maintain proper management incentives. Under such circumstances, taxpayers should be allowed to set prices using whatever method is most effective from a practical administrative point of view, and to then test the results that follow using an appropriate transfer pricing method.

Use of Transactional Profit Methods to Set Prices – Allocation of Risk

Using transactional profit methods to set prices may have different implications on the allocation of risk than using them to test ex post results. Taking risk into account is relatively straightforward when evaluating how transfer prices are set. However, the assumption of risk leads to ex post profit outcomes that may be either much higher or much lower than ex ante expectations. Under such circumstances, a taxpayer's financial results can fall outside the range established by comparables in any given year while still charging arm's length prices.⁸

⁶ The issues involved in using transactional profit methods to set vs. test prices are discussed in more detail in Clark Chandler and Steve Fortier, "Testing versus Setting Transfer Prices," *International Transfer Pricing* (8th Edition), *International Tax Review*, No. 28, 2006.

⁷ OECD Guidelines, paragraphs 3.11 and 3.30.

⁸ Simply as a matter of definition, half of the comparables used in a TNMM analysis will fall outside of an interquartile range.

The basic problem is that even if the controlled entity and a comparable third party assume the same risks when they enter into a transaction – and therefore the controlled and third-party transactions are comparable based on *ex ante* expectations – the two transactions are *not* comparable on an *ex post* basis unless the *outcome* of the risk has been the same. For example, assume that Related Party A commits to invest US\$500 million in the development of drug A under terms identical to Third Party B, which invests US\$500 million in the development of drug B. A and B both have identical expected probabilities of success and risk-adjusted expected profits. Ultimately, drug A is successful, while drug B is not. It is not possible to test the profits of drug A using the profits of drug B even though there were identical terms and risks *ex ante*, as the *ex post* outcome of the risk-taking is different.

Use of Transactional Profit Methods to Set Price – MultiYear Analyses

Tax authorities are inherently focused on an arbitrary period of time (the tax year) which often has no relationship with the underlying economics of the transaction. This can undermine the reliability of transactional profit methods when:

- Tax authorities fail to take into account costs that are incurred in one period but that do not generate sales until a subsequent period
- The impact of the assumption of risk by the controlled party is not known for a period of years
- When profits as reported in accounting data fail to accurately reflect the economics of an underlying transaction.⁹

Focusing on how prices are set rather than testing annual results makes it much easier to deal with investment projects that take place over a multi-year period. There are numerous cases in which an investment project will incur losses for several years in the expectation of covering such losses in subsequent years. Trying to test the taxpayer's financial results in any single year is likely to show that the taxpayer investing in such a project is: (i) earning below arm's length profits in the early years of the investment and (ii) earning above arm's length profits during the latter period of the project. Under such circumstances, there are numerous well established approaches that can be used to implement transactional profit methods on an up-front basis (looking at net present value; comparing expected profits to corporate hurdle rates; looking at internal rates of return). But the overall results of the project cannot be "tested" until after the project has been completed.

⁹ See discussion in Issue 10.

Are transactional net margin methods more appropriate for certain industries than others?

The appropriateness of transactional profit methods is more dependent upon economics, data availability and other substantive principles than upon industry identification. The OECD should be careful not to say that transactional profit methods are “generally” appropriate or not appropriate for industry X, as this may encourage the use of rote rules rather than careful analysis. Having said this, tax authorities should provide guidance on how they address transfer pricing issues that are specific to complex industries (e.g., global dealing, insurance, telecommunications, oil drilling). This could follow the format of the global dealing regulations issued by some tax authorities.

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

While taxpayers should be free to use two corroborating methods, there should be no need to support the results obtained when using a traditional method by a transactional profit method. More specifically, the transfer prices set using the traditional pricing methods should not be automatically rejected simply because they generate unusual profit results. Similarly, in cases in which the use of transactional profit methods should lead to essentially the same results as the use of traditional transaction methods, MNEs should be allowed to use either method. In such cases taxpayers may often prefer a transactional profit method as it may be easier to apply.

In cases in which a transactional method lead to results that are inconsistent with a transactional profit method, the most appropriate pricing method has to be determined, taking into account the various factors that have been covered in the discussion contained in Issue 1. As a general rule, KPMG believes that tax authorities should respect the selection of method made by the taxpayer as long as it is reasonable.

Issue 3: Application of Transactional Profit Methods and Intangibles

Many of the issues associated with the use of intangibles in the application of transactional profit methods are discussed elsewhere. As a general matter, transactional profit methods are often appropriate in cases in which intercompany transactions either explicitly or implicitly involve unique intangibles that taxpayers do not typically transfer to unrelated third parties. In such cases, the third party transactional data needed to apply the traditional methods may not exist, at least without adjustments that undermine their reliability. Under such circumstances, net margin methods may represent essentially the only reasonable approach.

However, the two categories of net margin methods (the TNMM and the profit split) are used very differently in this context. The TNMM is applied by focusing on one of the participants to a

transaction and using third party data to determine the profits that can be expected by that participant. This is often an effective way to determine the profits of low risk entities operating in a business structure in which the other party to the transaction (i) owns all of the key intangibles used in the business *and* (ii) is the key risk taking entity.

In contrast to this, a transactional profit split analysis is appropriate when each of the two participants to the transaction owns key intangibles *or* one of the two participants to the transaction owns valuable intangibles and the other incurs significant risks in exploiting those intangibles. (This is common in a typical licensing transaction in which the licensee invests significant amounts in the further development and/or exploitation of the licensed intangible.)

The lack of intangible ownership does not automatically imply that the TNMM is the best method. It is entirely possible that a legal entity may not own “intangibles” but nevertheless be entitled to profits that fall outside typical TNMM ranges because of the ownership of unique non-intangible assets (oil; large fixed assets; a large manufacturing plant), economies of scale, or the successful/ unsuccessful assumption of risk.

Issue 4: Application of the transactional profit methods and consideration of risk

Highlights

Risk has already been discussed at length in Issue 1 as it is a core element in the application of the transactional profit methods. At the same time, risk is one of the more misunderstood and misapplied concepts in transfer pricing. KPMG believes that the OECD Guidelines should help clarify the use of risk in the use of the transactional profit methods by emphasizing a few key points.

First, there is no single “correct” arm’s length allocation of risk. Instead, parties operating at arm’s length share risk in a variety of different ways. Companies engaging in intercompany transactions should have similar flexibility, and tax authorities should respect taxpayer decisions in this regard provided that they are made up front and are commercially reasonable.

Second, it is important to distinguish between *ex ante* allocations of risk and the *ex post* realization of the outcome of risk. The transactional profit methods should not be applied in a way that undermines the actual realization of risks.

Finally, risk is inherent in most business transactions and it is rare for any business entity to be completely shielded from risk. Tax authorities often assume that because MNEs want to earn profits, they necessarily all *do* earn positive profits. However, while it is reasonable to assume earning profits is a key business objective, it is *not* reasonable to assume that MNEs are always successful in reaching this objective. Even a contract manufacturer or a commission agent can

incur losses if their costs are higher than those of their competitors, if they make defective products, or if their customers fail to pay them.

Assumption of Risk

Unrelated companies operating at arm's length engaging in similar transactions may often make different decisions regarding the allocation of risk. For example, in a transaction between a television manufacturer and a television distributor/retailer, the two parties may:

- Decide that the manufacturer should be the key risk taker, with the distributor bearing limited risk; or
- Decide that the distributor should be the key risk taker, with the manufacturer bearing limited risk; or
- Decide to share risk in some other way.

Similarly, an entity that is carrying out R&D may either do this on its own account, in which case it bears the primary risk for the success or failure of that R&D, or may carry it out on a contractual basis for another entity, in which case it receives relatively certain payments with the entity paying for the R&D incurring the key risk.

The decision about how to share risks in an intercompany transaction is one that clearly has to be made up front and documented. It also clearly has to be consistent with the substance and conduct of the two parties to the transaction. Having said this, tax authorities should generally respect terms that are set forth up front that are consistent with the capabilities and practices of the two parties to the transaction.¹⁰ In this regard, recent work dealing with Permanent Establishment ("PE") issues has set forth an approach in which risk is assumed to follow function. Such an approach would disregard contractual arrangements established by taxpayers, and therefore should not be extended to the application of transactional profit methods.

Respecting the taxpayer's contractual allocation of risk has two important implications to the application of transactional profit methods. First, *ex ante* expected profit rates are likely to be higher for entities that take on substantial risks, and lower for entities that are protected from substantial risks. This is illustrated by the fact that investors in risk free securities generally accept an interest rate that is significantly lower than interest rates of junk bonds. Second, *ex post* outcomes from bearing risk are likely to lead to a greater range of operating profits for entities that are bearing significant risks than for entities that are partially shielded from risks.

¹⁰ See OECD Guidelines 1.36 and 1.41.

Multi-Year Averaging

Averaging represents one way of mitigating differences in the outcome of risks realized by the controlled entity and the comparables. If the results of the controlled entity over a business cycle (e.g., three years, five years) are compared with those of comparable companies over a similar period, the fact that the controlled entity had a downturn in year 2 while the various comparables had their specific downturns in year 1 in some cases and in year 3 in other cases may not matter, as the results of unusually bad years and unusually good years are averaged together.

Allowing the use of such averaging is important, as it increases the number of comparables that can be used. If results are compared on a year-by-year basis, the outcome of risk of the controlled entity and the comparables has to be the same for each year. If averaging is allowed, all that is required is that the average outcome of risk over a period of several years be the same for the controlled entity and the comparables.

Having said this, the use of averaging does not eliminate the need for a specific evaluation of unusual risk. If the controlled entity has a major adverse (or positive) outcome of risk that is not shared by the comparables, then the comparables are not comparable in terms of outcome of risk and cannot be used to reliably test after-the-fact results. Take the case of a distributor that bought Beta recorders from an affiliated supplier. There are ten comparable distributors, 9 of which bought VHS recorders from unrelated suppliers and the other of which bought Beta recorders from unrelated suppliers. The controlled entity and the comparables both invested in the distribution networks needed to sell recorders, and assumed the risk that sales would be sufficient to cover the costs of this investment and generate positive profits. The controlled entity is comparable to both the 9 distributors of VHS recorders and the one distributor of Beta recorders in terms of *ex ante* market prospects and risks. However, after several years the market decides that there is room for only one recorder format (VHS), and sales of Beta recorders disappear. At this point, the 9 distributors of VHS recorders have had a different *outcome* of risk and therefore their results can no longer be used to *test* the financial results of the controlled entity.

Issue 5: The Need for a Tax Administration to Have Access to All Information Needed to Apply or Review the Application of a Transactional Profit Method

Taxpayers should have the obligation to produce the information that is needed to support their selection of a particular pricing method, along with the detailed data needed to support their implementation of that method. This is true regardless of whether a transactional method or a transactional profit method is used. Dealing with transactional methods (CUP data, resale price method, cost plus method) raises many of the same issues as exist for the use of transactional profit methods. In this regard, one of the primary reasons that taxpayers often use transactional profit methods in documentation reports is that the data needed to apply the traditional pricing methods are not available.

However, tax authorities should limit the information that is required as part of the normal documentation process to those data that are needed to make a reasonable assessment of the taxpayer's transfer pricing under normal circumstances. In this regard, tax authorities have the ability to come back to the taxpayers if more detailed information is needed to assess a particularly important or unusually complex transaction. The OECD Guidelines should encourage tax authorities to discuss detailed initial requests for information with the taxpayer so that the taxpayer understands why the requested data are relevant, and has the opportunity to point out cases in which they are not relevant. This should lead to faster, less controversial and more effective audits by tax authorities.

It has also been KPMG's experience that tax authorities may reject the use of transactional profit methods that require the use of foreign comparables, either because they lack access to the data bases that are used in the searches or because they are reluctant to rely upon analyses using foreign GAAP. However, the selection and application of transactional profit methods should be guided by economic principles and functional analyses, and not be limited by the ability of tax authorities to access a particular data base or their familiarity with a particular GAAP. Instead, taxpayers should be allowed to address these limitations by providing appropriate documentation. While tax authorities need to be able to review the selection of the comparables used, if the taxpayer has done a thorough job of documenting the sample selection criteria (including maintaining information on the scope of the initial search and the reasons for rejecting specific comparables), the tax authority should not have to run its own search unless this involves going beyond the scope of the initial search (e.g., expanding the search to cover all transportation equipment rather than just automotive suppliers). Similarly, the taxpayer should be a source of information on relevant GAAP differences.¹¹

Finally, data limitations imply that transfer pricing analyses are generally based on imperfect information, which imposes inherent limitations to the precision of the analysis, as already acknowledged in the OECD Guidelines. Identifying a single correct price for any tangible or intangible transaction is often simply not possible, given that prices may vary even if perfect information were available, and will have an additional level of uncertainty given the imperfection in available data. Similar calls for a more flexible and realistic approach by tax authorities have been expressed and supported by all JTPF-members as part of the work performed by the EU Joint Transfer Pricing Forum [see Com (2005)-543 final of November 7, 2005, resulting Code of Conduct and underlying working documents].¹²

¹¹ Issues related to GAAP differences are discussed in more detail in the response to Issues 6 and 10.

¹² While we have generally not commented on the use of third party databases in comparables selection as beyond the scope of the OECD request, we would note that there are a large number of options and search strategies that are

Issue 6 – Application of a Profit Split Method: Determination of the Profit to be Split.

As a general proposition, the issues surrounding the definition of the profits to be split for the profit split method are similar to those of determining the appropriate measure of profits for the application of the TNMM. A discussion of these issues appears in Issue 10 below and much of that discussion is relevant here as well.

Several additional considerations should be taken into account in measuring profits for use in the profit split method. First, there is clearly the need for a consistent measure of profits in the application of the profit split. It would be unreasonable for one tax authority to believe that there are US\$100 in profits to be split while the other tax authority believes that there are US\$200 in profits to be split. Thus, while there may be a need to use local GAAP in a TNMM in order to compare “like with like” for local comparables, a consistent GAAP (or at least a consistent definition of the profit to be split) is needed in the application of a profit split analysis.

This is consistent with a much current practice. It has been KPMG’s Global Transfer Pricing Services experience that within the context of a multilateral APA, several European tax authorities agreed that the profit split would be established on the basis of consolidated financial statements made in accordance with the International Financial Reporting Standards (“IFRS”) and that they would only apply domestic law provisions (e.g. limited deductibility of certain expenses) on cost items that have been correctly accounted for in the local annual financial statements made according to local GAAP

Issue 7 – Application of a Profit Split Method: Reliability of a Residual Analysis and of a Contribution Analysis

Under a contribution analysis, all profits are split in the same proportion based on the contributions of the different parties to the transaction. Under a residual profit split analysis, there are two levels to the profit split, with one set of activities receiving an arm’s length price on the products, services or intangibles covered by those activities, and the profits (losses) that remain after paying that arm’s length price being split based on whatever profit split criteria are used.

A contribution analysis is most likely to be used when either there are direct third party data that can be used to determine the profit split or when profits are split based on relative contribution with risk shared in proportion to contributions. However, a residual profit split analysis is more likely to be used if there are accurate market benchmarks that can be used to fix the prices or profits of some of the goods and services supplied by one or more of the parties to the transaction. Consider the case in which Affiliates A and B are sharing in the production and sales of plastic toys produced by

available. The OECD Guidelines should acknowledge that taxpayers can only be expected to make a good-faith effort to consider the data available and to use it as well as possible under the given circumstances.

A and sold under B's trademark. The production of plastic toys requires the use of plastic as a raw material. The "value" of this plastic is conceptually equal to the price that would be paid to an unrelated third party. Therefore, if Affiliate A is supplying the plastic raw material rather than an unrelated third party, the residual profit split analysis first determines the arm's length price for raw material, pays A this price (or the profits associated with this price), and then splits the profits that exist after this payment has been made.

A residual profit split analysis is obviously appropriate when there is a clear delineation between the products or services that are receiving an arm's length price and the activities that are subject to the profit split, as in the example cited above. In addition, however, a residual profit split analysis may be appropriate when one set of activities (the routine activities) receive a preferential claim to profits, while the remaining activities share the risks that exist after making such preferential payments. When viewed in this way, a "contribution analysis" is consistent with situations in which all shareholders have an equal claim to profits or where two lenders are treated equally in the event of a default. A "residual analysis" is analogous to a situation in which some stockholders hold preferred shares while others hold common shares, or to a situation in which one loan is subordinated to another.

Both contribution and residual analyses may be appropriate, depending upon facts and depending upon the contractual allocation of risk among the participants to the transaction. As a simple example, consider a transaction in which Affiliate A invests in (i) product design (\$15) and (ii) the expenses associated with launching a new product (\$25) while Affiliate B invests in (i) process development (\$15) and (ii) the construction of a new manufacturing plant (\$45). Three equally plausible arm's length agreements are that:

- Affiliates A and B agree to split profits in proportion to their total investments (in which case Affiliate A receives 40 percent of total profits while Affiliate B receives 60% of total profits).¹³
- Affiliates A and B agree to first give an arm's length return to certain investments (say product launch and the construction of a new plant) and to then split the remaining profits on the basis of their investments in product and process design (in which case Affiliate A first receives a "guaranteed" return on its investment in product launch and then receives 50 percent of residual profits¹⁴ while Affiliate B first receives a "guaranteed" return on its investment in the new manufacturing plant and then receives 50 percent of residual profits).

¹³ $\$15 + \$25 = \$40$. $\$15 + \$45 = \$60$. $\$40 / (\$40 + \$60) = 40\%$.

¹⁴ $\$15 + \$15 = \$30$. $\$15 / \$30 = 50\%$.

- Affiliates A and B agree to first give an arm's length return on investments in product and process design, and to then split profits based on investments in product launch and in the new manufacturing plant (in which case Affiliate A first receives a "guaranteed" payment on its product design expenses and then receives 36 percent of residual profits¹⁵ and Affiliate B first receives a "guaranteed" payment on its investment in process development and then receives 64 percent of residual profits).

The OECD Guidelines should explicitly acknowledge that profit split analyses also include a split of negative outcomes of risk (e.g., losses) as well as positive outcomes (e.g., profits). Loss splits may be especially common in the case of residual analyses. In many industries, the most that participants to a transaction can expect over the long run are normal or routine profits. Under such circumstances, once routine profits are distributed, residual losses are just as likely as residual profits. The use of a residual "loss" split may be especially appropriate in cases where the application of the TNMM to each party to the transaction leads to combined profits that are consistently in excess of the total system profits associated with the transaction. Such a situation suggests that the TNMM is systematically overestimating the total profits that are available, and the application of a residual loss split may represent one way of correcting this overestimation of profits in a way that is fair to both legal entities.

A residual analysis in the broadest sense – e.g., an analysis with a two-tiered allocation of profits and losses -- may sometimes be needed to avoid commercially unreasonable results in the case of losses. For example, in the financial services industry, the allocation of profits is often driven by the number of trades, value of trades, and the contribution of the traders. If the business is generating losses due to high fixed costs, there is some question as to why the affiliate with the most active and successful traders should bear the brunt of the loss. This problem occurs because there is one activity that provides a significant contribution to profits (e.g., trading) and another that bears a significant share of the risk (e.g., investment in the business infrastructure). In such cases, it may be appropriate to have different allocation keys for assigning profits to trading activities and to fixed costs.

Issue 8 – Application of a Profit Split Method: How to Split the Profit

Basic Concepts: Contributions Vs. Risk

As a general matter, the key factors determining the allocation of profits in a profit split analysis are (i) the contributions of the parties to the transaction *and* (ii) the allocation of risks among those parties. The contributions of the different parties to the transaction can be measured using external benchmarks that provide direct evidence on how profits are split at arm's length, by the calculated economic value of external benchmarks (e.g., the net present value of an expected stream of royalty

¹⁵ \$25 + \$45 = \$70. \$25 / \$70 = 25%.

payments), or internal data such as net investments. Each of these approaches can be a reliable measure when used appropriately.

Risk is the second key determinant of how profits are split. While it is relatively common to suggest that profits should be split based on some objective criteria such as, for example, relative assets, such an approach assumes that the entities have agreed to a very specific sharing of risks; namely that every dollar of assets will command an equal level of risk. While such an allocation of risk is clearly one of the ways in which risks are shared at arm's length, it is not the only way -- an equally reasonable scenario may be that one of the two parties to the transaction agrees to bear twice the amount of risk per dollar invested.

If the two parties to a transaction have agreed to split risk based on relative investments or capital employed, each of the two entities should expect to realize the same rate of return. On the other hand, if one of the two parties has agreed to bear twice the risk per dollar of investment/capital employed, the entity bearing the greater risk should (i) expect to earn greater profits on an *ex ante* basis than the entity with lower risks; (ii) should earn a higher *ex post* rate of return than the entity bearing lower risks if the transaction is successful, and (iii) should earn a lower *ex post* rate of return than the entity bearing lower risk if the transaction is less successful than expected.

External Data

External data can provide direct guidance on how third parties would split ongoing profits or can be used to measure the relative contributions of the different parties to the profit split. The former occurs when the third party data consist of a license or other agreement that has payments/pricing between the parties that are dependent upon profits. Examples of such agreements may include:

- License agreements that call for an explicit sharing of profits
- License agreements that have royalty rates that vary depending upon profits (e.g., stepped royalties)
- Third party transactions with contingent payment terms generally
- Pharmaceutical co-marketing or co-promotion agreements
- Possibly non-conventional transactions such as joint venture agreements.

In some cases, indirect analyses based on third party data may also provide useful information in determining how profits should be split. For example, if a taxpayer has substantial experience in licensing to unrelated third parties, the rules that it uses in negotiating licenses with third parties may provide information that can be applied in determining the royalties charged in controlled

transactions covering similar intellectual property. As an example, if a taxpayer's licensing practice is to negotiate an upfront fee of 10 percent of expected profits plus a 50:50 split of remaining profits when it enters into a third party license, this may provide a profit split rule that can be applied to its related party transactions.

Alternatively, third party data can be used to determine the aggregate value of the intangibles assets that contribute to the transaction. For example, if Affiliate A is contributing trademarks and Affiliate B is contributing product/process intangibles, it may be possible to compute the net present value of each expected contribution based on third party royalty rates. The relative values of each contribution can then be used to allocate profits.

No External Data

In cases where it is difficult or impossible to develop reliable third party data other measures of relative contributions have to be developed.

As a general matter, such allocation keys can be divided into:

- Asset based allocation keys (operating assets, fixed assets, intangible assets)
- Relative spending and/or investment in key areas (e.g., R&D, engineering, marketing).

In some cases, such internal measures of the relative contributions of the two parties can provide direct and reliable criteria for determining a profit split. For example, if one party to the transaction is contributing product intangibles that cost US\$20 million to develop and the other party is contributing process intangibles that cost US\$10 million to develop, the use of a 67 percent:33 percent profit split in favor of the party contributing the product intangibles is likely to be as good and as reliable an answer as can be expected. (Assuming that the two parties agree to share risk in the same proportion as their relative contributions.) This is particularly true for asset-based measures, which have the natural advantage of being a measure of the relative investments that different parties have contributed to the transaction. Moreover, splitting profits based on relative assets is an approach that is commonly used in other types of transactions, such as partnerships and joint ventures. Relative spending and/or investment in key areas can also be used as a way of determining a profit split when such spending is thought to be made in essentially the same proportion as asset values.

In most cases, allocations based on relative spending divide spending into "routine" spending that does not generate a claim to a share of profits and "non-routine" spending that does generate such a claim. In making such a determination, it is important to differentiate between spending that is made on an at-risk basis (e.g., with genuine uncertainty as to whether it will generate sufficient sales

so as to yield profits) and spending that is likely to generate profits. The former is an at risk investment that should have a claim on profits if the investment is successful. The latter is not entitled to a risk-based return, and therefore generally is only entitled to a claim on profits if it reflects an intangible contribution.¹⁶

In some cases, the issues associated with the measurement of specific asset or spending contributions may be such that more generalized measures of functional contributions should be considered. For example, in the financial services industry profits may be allocated by relative trading activity rather than specific measures of spending. In other cases, industry practice may suggest typical allocations of profits among different functions such as manufacturing and distribution. While there is often a certain “arbitrariness” to such allocation keys, in some cases they may be no less precise than splits driven off of more complex computations.

Finally, in the case of transactions involving investments and income that take place over multiple periods, other economic measures may provide an appropriate way of determining a reasonable allocation of profits. One such measure may be equalizing the internal rate of return on cash flows, which essentially provides each participant an equal return on its contributions taking into account the timing of both expenditures and income.

Of course, in practice it is often difficult to develop a precise measure of the value of the specific contributions of the different parties. Therefore, allocations made under the profit split methods often involve a certain amount of professional judgment. The OECD Guidelines discussing the transactional profit methods should acknowledge this practical limitation.

Issue 9 – Application of the Transactional Net Margin Method: Standard of Comparability

Key Points

The application of the TNMM requires different standards of comparability than the traditional methods. In many cases, the comparability standards needed to the use of the TNMM are “lower” than those needed for the traditional methods – the use of the resale price method requires a consistent allocation of expenses between cost of sales and SG&A expenses; the use of the TNMM method generally does not.

However, there are also cases in which the comparability standards needed to use the traditional pricing methods may be “lower” than those needed for the TNMM -- differences in capacity

¹⁶ Similarly, defining an activity as routine or non-routine depends on the context in which the activity is performed. For example, for a chemical manufacturing company, the transportation of the chemicals may be considered routine. However, for a company specializing in transportation of chemicals, transportation may be a key value driver.

utilization may be have a significant impact on operating margins and therefore effect comparability under a TNMM but may have little affect on comparability under a resale price method or cost plus analysis. This issue occurs when factors other than transfer prices have a significant impact upon operating profits.

Aggregation issues are another important issue affecting comparability under the TNMM. Often, the only available data on third party comparables are at a company-wide level. Such data represent an average of the financial results of the more successful and less profitable products of the company. When these data are compared with more narrowly defined business segments, the more successful and less successful products may fall outside of the observed range of results solely because overall averages are being compared to specific product results. Tax authorities should be strongly discouraged from taking advantage of this situation by making adjustments when these comparisons are in their favor while ignoring cases in which such comparisons work in favor of the taxpayer.

Comparability Standards

The application of the TNMM raises different standards of comparability than the traditional pricing methods. On the one hand, there are a number of situations in which third party transactions that could not be used as comparables under the traditional methods can be used as comparables in the application of the TNMM. TNMM analyses allow, to an even greater extent than transactional resale price and cost plus analyses, the use of data on a more disparate set of products than would be possible under a CUP analysis. A CUP analysis relies on specific product comparability, and the price of a conventional television set cannot be used to infer the price of a HDTV set (at least without substantial adjustments). However, to the extent that the functions involved (which are reflected in the operating expenses of the company, e.g., SG&A in the case of the resale price method) and market attributes are the same for the two types of television sets, a transactional resale price/cost plus analysis may allow for the use of a gross margin derived from sales of conventional television sets in uncontrolled transactions to determine the transfer prices for controlled sales of HDTV sets.

But the application of a traditional resale price analysis/cost plus analysis continues to rely upon a high level of consistency in terms of both functions and accounting methods. A TNMM analysis is a logical extension of this in that it allows for the use of operating margins realized in the sale of products that may have different operating expenses to determine the operating profits that would be expected in the related party transaction. As a specific example, a third party distributor that sells to a large number of small customers may incur significantly higher SG&A expenses as a percent of sales than an affiliated distributor that sells to larger customers. This may disqualify the third party distributor as a comparable under a resale price analysis but may allow the third party distributor to be a comparable under a TNMM analysis.

On the other hand, there are also cases in which a third party transaction may be an appropriate comparable under a traditional pricing method but may not be an appropriate comparable under a TNMM. This occurs when non-pricing factors have a significant impact upon the profit measures used under a TNMM while having little impact upon the pricing measures used under the traditional transactional methods. As a simple example, changes in the level of capacity utilization may have little impact upon a gross cost plus markup while having a significant impact upon net profits. Therefore, a third party transaction in which the third party has a different level of capacity utilization than the controlled party may be an appropriate comparable under a traditional cost plus method but may not be an appropriate comparable under a TNMM.

More generally, the transactional profit methods, including the TNMM, provide an alternative way of addressing comparability issues than the traditional transactional methods. While a CUP analysis has to distinguish between a specific transaction that generates high profits from one that generates more typical profits based on comparability alone, transactional profit methods can evaluate the transactions as a group. The price that is paid for computer maintenance services may be much higher when those services are provided as part of a maintenance contract than when they are sold separately with no associated computer sales. A CUP analysis (or a resale price/cost plus analysis) has to address this issue on the basis of comparability alone – the sale of maintenance services made in conjunction with equipment sales may not be comparable to the sale of maintenance services made independently of any equipment sales. A TNMM can address this issue by combining the two transactions and evaluating them as a single transaction.¹⁷

Use of Company Wide Data in a TNMM

While there are some cases in which it is possible to select external comparables which perform only one type of activity (e.g. a distributor of PCs), it is often the case that data on third party comparables may only be available at the company-wide level. The use of such company-wide external data often implies that financial results have been averaged across products and/or countries, which can significantly reduce the variability in observed financial ratios. This problem is often compounded when tax authorities further limit the range of observed results in a one sided way (e.g., by eliminating comparable companies that have losses while leaving in comparables that have extraordinary profits; by defining the lower bound of the appropriate range as the median or average result; focusing on individual years and making adjustments when results are “out of the range” in one direction but not the other).

It has been KPMG’s experience that such company level data are often then compared with much more specifically defined internal data, as such more narrowly defined groups can often be derived

¹⁷ See Sean Foley, Erik Skarstad, and Anne Welsh, “Practical Approaches to Difficult Transfer Pricing Issues,” *International Transfer Pricing* (8th Edition), *International Tax Review*, No. 28, 2006.

from the taxpayer's internal financial records. The profitability of these more narrowly defined product groups is often higher or lower than the profitability of the comparables solely because the latter have been averaged over a broader base due to normal variations in profitability across product lines. Such variations may occur for a variety of reasons, with just a few examples listed below:

- When the sales and prices of one product depend upon the sales and prices of another product (blades/razors; product sales/after sales services). In such cases, the profits realized on the sale of the initial product may differ from those of the follow-on sale, either for real economic reasons (the initial sales price is discounted to generate higher sales, a higher installed base, and higher follow-on sales) or for accounting reasons (a greater portion of the sales effort may be allocated to the sale of the initial product, especially if the follow-on sales are made in subsequent years).
- There are sales of high end and low end products with different margins (e.g., sales of entry level cars vs. sales of high end luxury cars). The margins may differ on these two sets of products as the sale of low end cars may be viewed as an important way of building brand recognition and customer loyalty.
- Differences in where products are in their product life cycle: Profit margins may vary over product life cycles, and therefore similar products in different phases of their product life cycles may have different profit margins.

Such comparisons can lead to biased outcomes when tax authorities "cherry pick" by focusing on individual products or product lines that should logically be analyzed as a group. Such cherry picking may lead to non-arm's length overall results when products in a group that should be analyzed collectively are adjusted upward when they are below some range and left untouched when they are above the range, or *vice versa*.

Given this, the OECD Guidelines should strongly discourage such "cherry picking" on the part of tax authorities. Moreover, the OECD Guidelines should explicitly acknowledge that there are cases in which the analysis of the products as a group is likely to lead to more accurate results than the analysis of individual product results, e.g. when:

- Common functions and risks are carried out across different products in transactions between the same seller and buyer
- The loss of accuracy associated with increasingly fine and possibly arbitrary allocations of operating expenses more than offset any gains in accuracy realized by focusing on more narrowly defined groups.

- The sales and prices of one product depend upon the sales and prices of another product (blades/razors; product sales/after sales services).

Issue 10 – Application of a Transactional Net Margin Method: Determination of the Net Margin

Measures of Profitability

EBIT (earnings before interest and taxes) is probably the most commonly used measure of transactional profits. EBIT has a generally accepted definition that enhances its reliability for comparing financial results, and is a conventionally accepted measure of operating profit in evaluating a transaction or business. In certain circumstances, gross margin (revenue less cost of goods sold and / or services provided) can be a useful measure as well. (See discussion below.)

Profit measures generally have to be converted into a ratio (profit level indicator) for use in the application of a TNMM. There are two general types of profit level indicators that are commonly used:

- Rates of return (return on operating assets, return on capital employed) which are computed by dividing a flow of profits by a stock of assets
- Profit margins (operating margin, Berry ratio, gross margin, net cost plus) which are computed by dividing a flow of profits by a flow of expenses.

Rate of return measures are the more general measure of economic performance and conceptually allow for comparisons across a more diverse set of industries/economic activities than profit margin measures. Profit margin measures are more closely related to typical price-setting policies, and in some cases may be less subject to distortions between accounting and market measures of profits. Finally, alternative measures of profits (internal rate of return, weighted average cost of capital) may be needed when evaluating profits over a multi-year period.

A detailed discussion of the attributes and issues associated with different measures of financial performance is a complex topic that would require a detailed discussion in and of itself. Several key points are important, however. To begin with, the selection of a particular measure of operating profits will depend upon what it is being used for. In this regard, transactional profit measures can be used as:

- A yardstick for comparing third party financial results with the results of the tested party. This use of transactional profits in a TNMM analysis places a premium on defining profits in a way that maximizes the accuracy of the “yardstick”. In this case, the primary focus should be comparing like with like, so that comparability analyses should use the

profit measures that will be most consistent across the entities, and least sensitive to potential accounting differences or irrelevant influences.

- A measure of whether the transaction is profitable and the economic benefits that each party realizes from the transaction. In this case, the primary focus should be on determining how accurately the transactional profit measures reflect real drivers of economic decision-making and therefore requires a greater focus on the question of whether accounting profits are an accurate measure of economic profits. The selection of profitability measures that focus on economic benefits should be the primary focus of analyses that assess a taxpayer's financial interests in a transaction.

In both cases, the income and expenses to be considered should be limited to income and expenses (direct and indirect expenses, including G&A) relevant to the transaction at hand. At the simplest level, if the transaction involves the manufacture and sale of bicycle parts, income and expenses associated with ski rentals should be excluded from the analysis.¹⁸ Similarly, expenses related to capital structure (e.g., the decision whether to acquire capital by debt or equity) should generally be excluded from the analysis.

There are some cases, however, in which the expenses taken into account in measuring profit may vary depending on whether the objective is to develop an accurate yardstick for comparing profits/determining prices or to evaluate the economic rationality of the business and pricing decisions. Pension costs for retired workers, for example, may vary significantly from firm to firm, and may vary significantly between the tested party and the comparables. However, such pension costs are unlikely to affect current pricing decisions. Therefore, the most accurate yardstick for determining the relationship between price and cost that can be taken from the comparables and applied to the tested party may be a measure of costs that excludes pension costs for retired workers.

Pension costs for retired workers may play an important role, however, in evaluating the economic performance of the tested party, and in explaining why the tested party may continue to operate for a period of years even though it incurs losses. Such pension costs may be a fixed obligation that does not vary with current economic activity, and therefore the tested party may be better off remaining in business rather than shutting down even though it incurs losses once pension costs for retired workers are taken into account.

It is also important to realize that accounting measures of profits are at best only approximations of true economic profits. Accounting rules are designed to provide standardized decision-making

¹⁸ This is an ideal standard. In practice, this ideal has to be balanced by the relative magnitude of ski and bicycle sales, the reliability of segregation, etc.

about how certain expenses are treated – e.g., the period of time over which an asset can be depreciated is often fixed by type of asset, and therefore may not reflect the economic reality of how long an asset will actually be in service. Such issues often arise when companies have significant acquisitions that result in the revaluation of both tangible and intangible assets to “market” value. In such cases, EBITDA may be the more appropriate measure, and it may be appropriate to exclude book intangible assets from the analysis, as such book intangibles assets are typically the result of acquisitions, and do not include internally developed intangibles.

More generally, the use of specific measures of financial performance may lead to distorted results when there are significant differences between book and market value. Situations in which such differences are likely to occur include: land, mineral resources and other assets that may be depreciated for accounting purposes but which may appreciate in terms of market value; long lived assets generally; assets that have been subjected to large write-downs.¹⁹

Given the above, the relative merits of the different profit level indicators vary depending upon circumstances. Taxpayer should be expected to show that the indicator that they selected is appropriate and is the most reliable yardstick and/or measure of the economic profits. However, they should be free to choose whatever particular profit level indicator is most appropriate.

Consistent GAAP

Many countries have their own specific accounting standards, and therefore the financial results of taxpayers may vary depending upon whether they are measured in local GAAP or parent company GAAP. Moreover, many of the public databases that are routinely used in transfer pricing analyses continue to pull raw data from financial statements, so it is very common to find comparables reporting under different GAAPs.²⁰

Such issues make it difficult to compare “like with like” using accounting data that have been prepared in a consistent fashion. Moreover, it complicates the compliance process for multinationals in that they may have to prepare documentation in multiple different GAAPs -- a

¹⁹ While differences between book and market values can be important, it is simply not feasible to require that accurate estimates of market value be developed in TNMM analyses. This would not only be expensive, but would require extensive knowledge of, and possibly the re-characterization of, the financial statements of the comparables.

²⁰ Over time, this issue of multiple GAAP standards is likely to decrease as many countries are moving toward International Financial Reporting Standards (IFRS). So over time, most comparables should report under the same GAAP. However, the complications associated with using data reported under different accounting standards will continue for several years after such conversions, as many of the public databases do not revise all historic data. In the EU, many listed companies only converted to IFRS in the past couple of years. Therefore, the data contained in public data bases may be in local GAAP figures for the earlier years and IFRS figures for the more current years.

parent company in Japan selling to distribution affiliates in China, the U.S., Germany and Argentina has to deal with 5 different GAAPs, all of which presumably have some variations in how they measure EBIT. Preparing documentation in multiple GAAPs can significantly increase the complexity and cost of complying with documentation requirements.

There are no perfect or easy solutions to this issue. However, the OECD Guidelines should encourage flexibility in addressing the issue, recognizing that:

- In some cases local GAAP accounting may not make much of a difference in financial results
- The key issue is comparing “like with like,” and there may be different ways of reaching this goal (e.g., selecting a profit level indicator that is not as sensitive to local GAAP differences; using data from a harmonized standard data base that has adjusted data for consistency rather than relying upon local databases where such adjustments have not been made)
- Any GAPP measure of profits is only an approximation of the profits that would be taken into account in setting prices at arm’s length or in measuring economic profits, and allowing taxpayers flexibility in making the adjustments needed to make the various data more reliable.

Gross vs. Net Margins

Net margins are generally more appropriate than gross margins in the application of the TNMM. Net margins are less sensitive to functional differences than gross margins, and there are many cases in which the functional comparability needed for a reliable gross margin analysis cannot be realized. Gross margins are also sensitive to the split of costs between costs that are included in the cost base and costs which have to be covered by the margin, which further limits their use given practical constraints on data availability.

At the same time, it is important to realize that gross margins and net margins are measuring different things. Net margins are an all-in measure of profits, and are more likely than gross margins to be effected by factors that are not related to pricing. For example, the gross margin used in a resale price analysis is unlikely to be affected by factors such as sales volume. Net margins, however, may be very dependent upon such factors, particularly if there are significant fixed costs. Therefore, taxpayers should be allowed to use gross margin measures to the extent that this is consistent with the economics of the transaction. Also, taxpayers may be able to provide gross margin data specific to the transaction at issue, while net margin data would need to be created based on allocations. The determination of whether gross or net margin data provides the most

reliable basis for comparison is fact specific; again taxpayers should be free to use the most reliable measure subject to an ability to document the basis for their selection.

Issue 11 – Other methods

Taxpayers should be allowed to use whatever pricing method is most appropriate in terms of giving the most accurate answer with a reasonable expenditure of effort, including formulary approaches. In most cases, this is likely to involve the use of one of the methods that are listed in the OECD Guidelines. However, there are always going to be cases that cannot be anticipated, and therefore situations will arise in which the use of one of the specified methods may not be appropriate. Illustrative examples of such situations include:

- Global dealing of financial services, where both the OECD and the US have conceded that different approaches have to be used.
- Transactions in industries with unusual economic attributes. In software, for example, there is often a very limited relationship between the cost of developing and producing software, the price that is charged for it, and the profits that are realized from sales. This undermines many of the economic assumptions that are implicit in the application of the listed methods.
- Multi-year transactions in which expenditures in one year lead to revenues and profits in future years. The listed methods are focused on what occurs during the audit year, and are often ineffective in dealing with multi-period transactions in a reasonable way.

Finally, prohibiting the use of “other methods,” when coupled with a relatively rigid view on the part of the tax authorities on the definition of the listed methods, may also lead to unnecessary disputes in cases in which a taxpayer uses an unusual but reasonable application of one of the methods.

Issue 12: Other Issues

Payments Used to Correct Arm’s Length Results When Taxpayers Fail an After-the-Fact Test:²¹

If net margin methods are used to test *ex post* results at the end of a year, there is the possibility that they will “fail” the test. Under such circumstances, tax authorities are likely to expect taxpayers to

²¹ See Steve Felgran, Yoko Hatta, Anthony Seve, “How to Handle Year-end Adjustments” International Transfer Pricing (7th Edition), International Tax Review, No. 23, 2005

adjust their transfer pricing after-the-fact, implying that there is the logical need to fix or correct past results. Such corrections typically involve year-end payments, payments that are often made after the fiscal year has closed but before the tax return filing.

Such year-end adjustments present serious issues. Year end adjustments are typically in conflict with other regulatory requirements – in particular VAT and customs rules. Moreover, even though there are a number of third party arrangements -- discounts based on cumulative sales volume, price protection, take or pay arrangements-- that call for a retroactive adjustment to prices, tax authorities in many countries take the position that third parties generally do not change prices based on after-the-fact results, and therefore disallow such adjustments. In some cases, the year-end adjustments may also be viewed as a domestic issue arising from a voluntary contribution rather than an international issue. Under such circumstances, taxpayers may not even have access to Competent Authority relief.

Taxpayers that use transactional profit methods to test after-the-fact results should have access to an effective mechanism for dealing with the issues set forth above. If the level of profits is considered to be arm's length, the nature of the payments made to achieve that level of profits should not prevent acceptance of such adjustments.

Adjustments to a Given Point Within a Range

While the use of transactional profit methods often establishes a range of reasonable arm's length results, ultimately transfer prices are set a specific point within the range. KPMG believes that any point within a reasonably defined range should be acceptable in terms of complying with regulatory requirements.

When tax authorities make adjustments on audit, existing OECD Guidelines indicate that an adjustment should be made in such an event to the point within the range that best reflects the facts and circumstances of the relevant intra-group transaction. While this is reasonable if there are grounds for assuming that one specific point within the range comes closest to replicating the conditions under which the intra-group transaction took place, tax authorities should be discouraged from using this principle to select a point solely because this leads to the best local result. The median may be the most logical default point under many circumstances.