

**Chaire de recherche
en fiscalité et en
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**OECD – Comments on the use of
Transactional Profit Methods
in Transfer Pricing**

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Mission of the Research Chair in Taxation and Public Finance

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Table of contents

Mission of the Research Chair in Taxation and Public Finance	i
Introduction	1
1 Review of transactional profit methods: status as last resort methods	3
2 Use of more than one method (use of a transactional profit method in conjunction with a traditional transaction method, or sanity check)	5
3 Access to the information needed to apply or review the application of a transactional profit method	6
4 Application of transactional profit methods and unique contributions	7
5 Application of the transactional net margin method: standard of comparability	8
Conclusion	10

Introduction

The Chair's recent work has addressed the question of aggressive tax planning. We recently produced a number of studies regarding tools used in other tax administration in order to counter this phenomenon. Transfer pricing has been identified as one of the main avenues to lower taxation for taxpayers, especially Multinational Enterprise Groups (hereafter "MNE"). The Chair expects to begin an exhaustive review in the area of transfer pricing later in 2008. As part of our preliminary findings, we have taken the opportunity of this solicitation of public comments by the OECD to address some of our concerns with regard to the use of transactional profit methods.

As the preoccupation of the OECD has been on ways to improve compliance for taxpayer in the context of the arm's length paradigm, we were not surprised by the fact that Working Party no 6 made only one, and perhaps ultimate, comment on the use of other approaches to the actual transfer pricing paradigm, namely the formula apportionment.

It is outside the scope of the present solicitation of comments to discuss the OECD actual¹ consensus on the use of the arm's length principle. However, considering this principle causes some practical difficulties both for taxpayers and tax administrations, we find it useful to readdress our concerns about this issue, which has some implication with regard of the use of transactional profit methods.

The arm's length system was developed in the 1930s in a world where trade dealt principally with raw materials, commodities or finished manufactured goods. Today, in fact well before today, trade has more to do with vertical integration of firms, high value services, intangibles, globalization and off-shoring.

The 1995's OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administration (hereinafter the "TP Guidelines") highlight at paragraphs 1.8 – 1.10 some inherent deficiencies of the arm's length principle. Of those concerns, we retain the very basic one dealing with the capacity of a MNE to achieve higher revenues from its different subsidiaries than those subsidiaries would have achieved in acting alone. Internalization, along with Ownership and Location², will lead MNEs to establish subsidiaries in foreign markets instead of dealing with arm's length local enterprises.

Thus, there is an economic advantage for foreign affiliate entities of a transactional enterprise over local firms. Transfer pricing should deal with the proper allocation of those economic advantages between the local firm and its foreign affiliate group even though the arm's length principle do not recognize them in its pure application.

¹ The European Commission is working on a model of common consolidated corporate tax base (CCCTB) that could represent a significant departure from the arm's length principle by significant OECD members. See http://ec.europa.eu/taxation_customs/taxation/company_tax/common_tax_base/index_en.htm.

² In reference to the eclectic OLI paradigm developed by John H. Dunning (1998).

Notwithstanding this preliminary concern regarding the arm length principle, we consider that enhancement of the actual paradigm is more appropriate than maintaining the rigid traditional approach. Taxpayers have to rely on transactional profit methods due to the lack of good quality transactional information to apply to a traditional transactional method. It is problematic to obtain public transactional information for several industrial sectors in United States. It is even more difficult for smaller economies like Canada or Australia to obtain such information. Needless to say, we are particularly concerned about conceptual difficulties in applying the arm's length paradigm encountered by tax administrations in emerging economies.

In order to enhance compliance from both taxpayers and tax administrations, we find it constructive to present our comments on the discussion draft dealing with those issues. As the Working Party is also seeking to complete the TP Guidelines on the application of the transactional net margin method ("TNMM") and the profit split method, we have decided to make only a few comments on those more specific and specialized issues (issues 6 to 9).

Review of transactional profit methods: status as last resort methods

We totally agree that all references to the use of transactional profit methods as being exceptional should be removed. Business commentators have given strong indications that those methods are in fact more utilized than the traditional transaction methods. Statistics released by IRS³ and the Canada Revenue Agency⁴ show that transactional profit methods are far more utilized in establishing Advanced Pricing Agreements⁵ than traditional transactional methods.

In the same way, the removal of the “last resort” status will lead to a better understanding of the particularity of the profit split method over the other [one-sided] methods. We agree that profit split is more appropriate for integrated cross-border operations or when there are significant contributions where no benchmark can be found or be relied upon. As a result, the profit split method should no longer be considered as a last resort method.

That being said, we wonder if TP Guideline should continue to refer to a hierarchy of methods or to a “most appropriate method for a particular case”. We recognise that traditional transactional methods are more direct methods. For TNMM, we consider that the computation of transactional net margins may result in subjective allocations of expenses.

In maintaining the preference in the utilization of traditional transactional methods, we expect taxpayers to continue to consider the use of traditional transactional methods before those that are profit-based, especially for the Comparable Uncontrolled Price method. Giving the same status for TNMM may result in taxpayers voluntarily eluding the use of resale or cost plus methods in situations where it would have been clearly more advised.

TNMM is really a method of last resort because its use does not result from theory applications but from practical reasons, including the lack of information when dealing with third party comparables. That being said, we are wondering if the following comment found at paragraph 3.2 upon transactional profit method is still appropriate:

It is unusual to find enterprises entering into transactions in which profit is a condition “made or imposed” in the transaction.

³ INTERNAL REVENUE SERVICE, Announcement and report concerning advance pricing agreements, March 27, 2008.

⁴ CANADA REVENUE AGENCY, APA Program Report for 2006 – 2007.

⁵ For 2007, Transactional profit methods were used in more than 75 % of the American APA’s cases. We are aware that APAs may not constitute a valid sample of the entire population. However, IRS explains that CPM (there is no reference to TNMM) is frequently applied in APAs because reliable public data on comparable business activities of independent companies may be more readily available than potential CUP data, and comparability of resources employed, functions, risks, and other relevant considerations are more likely to exist than comparability of product. IRS also mentions that CPM tends to be less sensitive than other methods to differences in accounting practices between the tested party and comparable companies.

This criticism may also be addressed to the use of resale price method or cost plus method. With the exceptions of stripped distributors or contract manufacturers, it is questionable that arm's length enterprises negotiate on a gross margin basis. We believe that this consideration should be removed.

Having expressed our concerns, we consider that the conclusions of the Working Party for this issue as generally adequate. We consider the proposed amendment to the TP Guidelines also as being adequate.

2

Use of more than one method (use of a transactional profit method in conjunction with a traditional transaction method, or sanity check)

We agree with the conclusions of the Working Party. The additional comments regarding the use of TNMM as a sanity check in proposed paragraph 3.27 will be beneficial. As for business commentators, we believe that the use of more than one method should not be a requirement, especially when dealing with smaller enterprises.

As paragraphs 3.27 to 3.29 of the TP Guidelines describe strengths and weaknesses of the TNMM, we believe that the comments expressed in paragraph 104 of the draft should be included in this section. This paragraph explains that TNMM may be less sensitive to volume than the cost plus or resale price methods. It makes clear also that TNMM may be more sensitive to differences in capacity utilization due to the absorption of indirect fixed costs.

3

Access to the information needed to apply or review the application of a transactional profit method

In general, commentaries received from business commentators recognize that tax administration should be given access to all relevant information needed to review the application of the transfer pricing method applied. We would agree with them if we knew what exactly they meant by “relevant”.

Presuming that tax administrations act responsibly, we do not think it is advisable to address the issue of what kind of information tax administrations should obtain. In this perspective, the actual paragraph 5.10 of the TP Guidelines should be revised accordingly. The conclusions reached at paragraph 52 of the discussion draft may provide some guidance to both parties as to what information should be expected to be produced in the process of revision by the Tax administration. We consider the conclusions reached by the Working Party as prudent. A restrictive view of what is relevant could create confusion over what taxpayers expect to provide to tax administrations during a revision process.

In spite of this problem, we have concerns regarding the information to be obtained in the case of one-sided methodologies. When the tested party is the domestic entity, taxpayers should be aware that the tax administration may request financial information from the foreign party in order to ascertain the information provided regarding the functional analysis. When both parties agree on the functional analysis, we agree with the Working Party that cost accounting information should not be requested from the foreign related party.

4

Application of transactional profit methods and unique contributions

In what cases involving unique contributions can a transactional profit split be the most reliable method to use?

Unique contributions are by definition... unique. Using a traditional transactional method when intangibles are involved is difficult and subjective. We agree that profit split method is the most reliable method for transactions involving valuable contributions.

In what transactions involving intangibles can a transactional net margin method be the most reliable method to use?

More guidance for the use of transactional net margin method when intangibles are involved will be helpful. As mentioned in the OECD draft, the licensing or transfer of an intangible property is a complex process of negotiation. We believe that the value of the intangible will mostly depend on the perceived value for the transferee. For this reason, we have concerns regarding the reliability of internal comparable for unique intangibles. Furthermore, in the context of non arm's length licensing or transfer occurring between affiliated entities, we expect it will be very difficult to appraise an independent process of negotiation. We believe that the approach described in the paragraph of the OECD discussion draft for the use of TNMM as a sanity check may be right and useful.

Finally, TP Guidelines on cost based approached in the transfer pricing determination of intangibles should be stricter concerning the deficiencies of this methodology.

5

Application of the transactional net margin method: standard of comparability

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)?

As long as the functions, risks and commercial strategies are the same, differences between the products or the services provided should not have a material impact.

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)?

In order to make a company-wide aggregation of data, the following elements must be present (assuming here the tested entity is a distributor⁶):

- That the tangible properties are bought from controlled suppliers only. The Comparable Profit Method (CPM) approach in the United States, as we understand it, proceeds with a general comparison of profitability with a company-wide net margin reported by a third party. If the tested party is buying from non related provider, such a comparison is flawed.
- That the related suppliers do not reside in countries where the corporate income tax rate represents a significant tax advantage in comparison with the tested party. If so, these transactions should be aggregated separately.
- That the functions, risks and commercial strategies do not vary significantly from one family of products to another. The comments found at paragraphs 111-113 regarding the “portfolio approach” will be helpful for this consideration. This concept will clarify that an enterprise may encounter lesser margins on certain goods or services for true business consideration. Thus, tax administration should not unduly segregate those transactions in order to make transfer pricing adjustments.

⁶ Those comments apply mutatis mutandis in the case of a manufacturer.

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)?

We do not consider appropriate to have a lower standard for aggregating transactions with the transactional net margin method. We may however aggregate different family of products as long as the functions, risks and commercial strategies are similar.

Conclusion

The maintaining of the arm's length paradigm is probably what may be called a necessary evil. We understand that a shift of paradigm to a new model may be illusory in the international context of fiscal policy. The problem of enforcement of compliance for tax administration may however decrease as global tax competition actually reduces corporate tax rates. Nevertheless, the issue of double taxation, and in certain cases, no taxation at all, will remain.

The 1995 TP Guidelines cause several practical difficulties due to the generality of its guiding principles. They are difficult to implement for some OECD members and emerging countries. The actual guidelines are probably viewed as idealistic for tax administration of Third World economies when dealing with MNEs shifting their profitability offshore.

We consider that the proposed amendments to transfer pricing guidelines represent a real improvement for the understanding of transfer pricing normative requirements, both for taxpayers and for tax administrations.