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To: Ms. Caroline Silberztein - CTP/TTP
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Do you authorize the OECD to publish your contribution on the Internet site
www.oecd.org/taxation?
 Yes, OECD may publish our comments
 No

This is in regard to your invitation to comment on transactional profit methods. Our contribution follows the questions presented by you.

Best regards,
Woo Taik Kim

Issue 1 - Status of transaction profit methods as last resort methods

We agree that the transaction profit method should be the last resort method in determining the arm's length price of future transactions. To test an outcome of already completed transactions, the same standard should apply without hindsight. In practice, there is a significant difference between the method for future transactions and the method for testing the outcome of completed transaction. Tax administration has shown difficulty in adopting the notion of evaluating future consequences.

The profit split method is preferred in transfer pricing of intangibles, in particular, marketing intangibles, where parties have been equally involved in development and use of such intangibles. Also, the method may apply to financial transactions where the parties concerned are involved in so much integrated manner. The transactional net margin method is favored in most of the industries where the products or services are

rather unique so as to make it difficult to search for comparables.

Yes, we regard the use of transactional profit methods as an appropriate solution in situations where there are no comparable data available or where the available comparable data are not of sufficient quality to rely on solely or at all for the traditional transaction methods.

The present hierarchy appears to be preferred to no hierarchy or change to the present order of preference.

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 transitional transaction method.

In practice, taxpayers would seldom suggest the use of the profit split method as a means for testing the outcome of the use of the traditional transaction method. Instead, tax administration would from time to time want to apply the profit split method as a test. One of the problems is taxpayers' concern or reluctance in disclosing the other party's profits. This is particularly true for a private company, whose stock is not traded in market. The transactional net margin method, in theory, may be used by taxpayers and not by tax administration because the latter usually generates lower profit or margin to the party in the other country.

Issue 3 - Application of transactional profit methods and intangibles

The profit split method is preferred where either party of the transaction contributed to development of marketing intangibles. Final products are manufactured in the second State while essential elements of the products are manufactured in the first State. Marketing activities are conducted in the second State with the global strategies and directing developed in and offered from the first State.

Manufacturing intangibles that were developed in both the first and second states may lead to the situation where both parties concerned were involved in an integrated manner. In such situation, perhaps, the profit split method may be considered as an appropriate solution.

Another circumstance is related to banking or securities dealing where globalized organization is in operations. Other cases are where industrial components are manufactured in the first State which are protected by a variety of patents; products are sold in second State under integrated, global marketing efforts. Division of marketing versus manufacturing intangibles would become one of controversial issues between taxpayer and tax administration and between taxpayer and either of the two tax administrations.

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

There are several factors to be considered in terms of risk. Those factors are where final products are manufactured, flow of sales proceeds (whether paid to overseas seller or domestic seller), pattern of paying advertising and promotional expenses, management of distributors in the country of sale, and activities of regional or local management center. It is difficult to single out a few factors in the normal integrated management environment.

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

Tax administration has difficulty in using the information in a proactive manner because the analysis tends to go beyond the classical taxation knowledge and requires, for example, economic analysis, in-depth information in a particular business industry, understanding of marketing fields, and engineering areas in some cases. The use of examples to illustrate difficult concepts should be helpful, and continuous training sessions for both taxpayers and tax administrations should be one of the ways to overcome such difficulty.

Issue 6 - Application of a profit split method: determination of the profit to be split

Accounting difficulty in developing a combined profit or net margin should be able to be overcome. There may be differences in the accounting of one or more material accounts that should be able to be adjusted in light of fairness standards. The level of profits or net margin that should be used depends on facts and circumstances.

Issue 7 - Application of a profit split method: reliability of a residual analysis and of a

contribution analysis

A residual analysis seemed to become reasonable where one party engages in particular business activities, such as manufacturing, while both parties were involved in other activities such as marketing and promotion including brand management or sports marketing.

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

This is one of the factors that are difficult to find external data. In practice, internal data are used such as the expenses spent by each party. In theory, a third party's data should be analyzed and if necessary with modification to the external data, the external data should be encouraged to be used. A few exemplary cases will be useful.

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

Specific elements in comparability are product group, level of marketing, functions performed, character of products, risk elements, and contractual arrangement. In general, the product group or nature of services concerned is a starting point, after which consideration is given to other elements such as functional analysis and contractual terms. Business strategies and economic circumstances are seldom used in comparability among potential comparable situations within the same country.

Issue 10 - Application of a transactional net margin: determination of the net margin

Net margin to sale is understandable. However, net margin to asset or net margin to cost needs elaboration and should be included in the TP guideline in an expanded manner.

Issue 11 - Other methods

There may be a modified method to the resale or cost plus method and the current Other Methods. The terms used in the so-called resale-minus method should be carefully defined. The profit split method may vary also depending on the nature of allocation key and the level of profits or margin that is to be split.

Issue 12 - Other issue

The arm's length principle is extended to the value of company stock that is transferred from one company to another company within the same company group. There must be some comments in the TP Guideline on stock valuation in addition to the existing coverage of continuous flow of goods or services.

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