



Transfer Pricing Commission at the National Economists' Association (Mexico)

Comments on the proposed revision to Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, Chapters I – III

Chapter I, Sections A – C

By: Iván Díaz-Barreiro – Ortíz, Sosa Ysusi y Cía., S.C.

Chapter 1. The Arm's Length Principle

A. Introduction

- 1.1 From old paragraph 1.1, unchanged.
- 1.2 From old paragraph 1.2, unchanged.
- 1.3 From old paragraph 1.3, unchanged.
- 1.4 From old paragraph 1.4, unchanged.
- 1.5 Based on old paragraph 1.5, edited.

The following sentence was eliminated (it started on line 9 of the old paragraph): "Tax administrations should bear in mind that MNEs from a managerial point of view have an incentive to use arm's length prices to be able to judge the real performance of their different profit centres."

Although what is stated in this sentence might be true, it is not related to the ideas exposed in the paragraph, which explain what factors influence the bargaining process between related parties.

B. Statement of the arm's length principle

i) Article 9 of the OECD Model Tax Convention

- 1.6 Based on old paragraph 1.6, edited.

First paragraph unchanged.

Quote unchanged.

Second paragraph edited. First sentence. It is stressed that the arm's length principle seeks to adjust profits by reference to the conditions which would have been obtained between independent enterprises "in comparable uncontrolled transactions". The remaining part of the paragraph, states how to determine if controlled transactions differ from those between comparable uncontrolled transactions. This is achieved by citing the definition of "comparable uncontrolled transactions" (which will be added to the glossary) and citing Chapter 1, Section C and Chapter 3.



1.7 New.

The paragraph talks about the need for a comparability approach that is reliable, but at the same time takes into account the burden it creates for taxpayers and tax administrations.

It then introduces paragraph 1 of Article 9 of the OECD Model Tax Convention as the foundation for comparability analyses. This paragraph states that the accounts of associated enterprises can be re-written (adjusted), whenever the conditions between them differ from the conditions that would have prevailed among independent enterprises.

1.8 From old paragraph 1.7, unchanged.

1.9 From old paragraph 1.8, third sentence newly added.

The new sentence talks about circumstances in which it is difficult to comply with the arm's length principle (i.e. when MNE groups deal with integrated production of highly specialized goods, unique intangibles, and/or the provision of specialized services).

1.10 Based on old paragraph 1.9, substantially unchanged.

1.11 Based on old paragraph 1.10, edited.

The old paragraph talked about controlled transactions that do not take place between unrelated parties, but gave too much attention to intangibles. It also was inconclusive, because it did not specify if this meant that controlled transactions comply or not with the arm's length principle. The new paragraph emphasizes that it cannot be concluded a priori that this kind of transactions do not comply with the arm's length principle, just because they do not exist in the market.

1.12 Based on old paragraph 1.11, edited.

The paragraph was substantially unchanged. It now cites Sections B and C of Chapter 3 and Chapter 5 on Documentation, instead of just citing Chapter 5 on Documentation.

1.13 Based on old paragraph 1.12, edited.

This paragraph talks about the difficulty of obtaining adequate information to apply the arm's length principle. The last part of the fifth sentence was modified and the sixth sentence is new. On one hand they highlight the difficulty of finding reliable information, but on the other, they see this as no excuse to not finding "a reasonable estimate of an arm's length outcome based on reasonably reliable information". The paragraph is confusing because it does not clearly state what to do if no "reasonable reliable information" is found. However, it cites paragraph 3.2 for a discussion about what does "reasonably reliable comparables" mean.

ii) Maintaining the arm's length principle as the international consensus

1.14 Based on old paragraph 1.13, edited.

The second sentence talks about property (such as goods, other types of tangible assets, or intangible assets), while the old sentence just mentioned goods.

1.15 Based on old paragraph 1.14, substantially unchanged.



C. A non-arm's-length approach: global formulary apportionment

Section C, Guidance for applying the arm's length principle, of the 1995 OECD Transfer Pricing Guidelines, was moved and now is Section D. This new section C is based on Chapter 3 of the 1995 OECD Transfer Pricing Guidelines.

i) Background and description approach

- 1.16 Based on old paragraph 3.58, unchanged.
- 1.17 Based on old paragraph 3.59, substantially unchanged.
- 1.18 Based on old paragraph 3.60, substantially unchanged.

ii) Comparison with the arm's length principle

- 1.19 Based on old paragraph 3.61, substantially unchanged.
- 1.20 Based on old paragraph 3.62, substantially unchanged.
- 1.21 Based on old paragraph 3.63, unchanged.
- 1.22 Based on old paragraph 3.64, substantially unchanged.
- 1.23 Based on old paragraph 3.65, unchanged.
- 1.24 Based on old paragraph 3.66, unchanged.
- 1.25 Based on old paragraph 3.67, substantially unchanged.
- 1.26 Based on old paragraph 3.68, substantially unchanged.
- 1.27 Based on old paragraph 3.69, substantially unchanged.
- 1.28 Based on old paragraph 3.70, unchanged.
- 1.29 Based on old paragraph 3.71, substantially unchanged.
- 1.30 Based on old paragraph 3.72, substantially unchanged.
- 1.31 Based on old paragraph 3.73, substantially unchanged.

iii) Rejection of non-arm's-length methods

- 1.32 Based on old paragraph 3.74, unchanged.



Chapter I, Section C

By: Jimmy Cruz – Ernst & Young (Mexico)

C A non-arm's-length approach: global formulary apportionment.

- i) Background and description of approach (1.16, 1.17 and 1.18)

In general terms I agree with these three paragraphs. Nonetheless, I suggest commenting that additional approach besides the Global Formulary Apportionment exists in practice. This could be the case of the Safe Harbor approach, which grants a predetermined percentage of profit to certain transactions, for example the Maquila (contract manufacturing) industry in Mexico used to have the option to follow pre-determined percentages of profits based on costs and expenses or as a proportion of assets used in the contract manufacturing activity. It will be also important to mention that although the Safe Harbor approach prevails in some tax regulations, it has been replaced gradually by the use of the arm's length principle and specifically by methods contained in local Tax regulations similar to those contained in the TPG.

- ii) Comparison with the arm's length principle (1.19, 1.20, 1.21, 1.22, 1.23, 1.24, 1.25, 1.26, 1.27, 1.28, 1.29, 1.30, 1.31).

In general I agree with these thirteen paragraphs. Notwithstanding, as for the idea contained in paragraph 1.23, lines 4, 5 and 6 with respect to the following: *"In addition, tax administrations would have to consider jointly how to address the potential for artificially shifting the production factors used in the formula (e.g. sales, capital) to low tax countries."* I suggest adding that this risk also exists when the arm's length principle is applied.

- iii) Rejection of non-arm's-length methods (1.32)

I entirely support the application of the Arm's Length principle as the international consensus suggests not only among OECD member countries but also among non-OECD member countries.



Chapter I, Section D - i

By: Gabriela Sicardi – Rivero y Olivares

1.38 Agree

1.50. We agree with that the quantity does not make up for poor quality of data

1.55 Agree

1.56 Agree

1.57 We suggest that it is important to mention the situation of Latin American countries regarding with the lack of public information of comparable domestic companies.



Chapter I, Section D – ii - v

By: Lourdes Fernández – PricewaterhouseCoopers

Chapter I. The Arm's Length Principle

Section D. Guidance for applying the arm's length principle

ii) Recognition of the actual transactions undertaken

- 1.63 From old paragraph 1.36, substantially unchanged.
- 1.64 From old paragraph 1.37, substantially unchanged.
- 1.65 From old paragraph 1.38, substantially unchanged.
- 1.66 From old paragraph 1.39, substantially unchanged.
- 1.67 From old paragraph 1.40, unchanged.
- 1.68 From old paragraph 1.41, unchanged.

iii) Losses

- 1.69 From old paragraph 1.52, unchanged.
- 1.70 From old paragraph 1.53, unchanged.
- 1.71 From old paragraph 1.54, unchanged.

iv) The effect of government policies

- 1.72 From old paragraph 1.55, unchanged.
- 1.73 From old paragraph 1.56, unchanged.
- 1.74 From old paragraph 1.57, unchanged.
- 1.75 From old paragraph 1.58, unchanged.
- 1.76 From old paragraph 1.59, unchanged.

v) Use of customs valuations

- 1.77 From old paragraphs 1.65 and 1.66 edited.

It is added an emphasis to the fact that associated enterprises are affected by the same relation that links them. It also adds a paragraph that states that the valuation methods may not agree with the methods recognized by the OECD guidelines. Finally, it also refers to the ability of authorities to have detailed information regarding the circumstances of each transaction.

- 1.78 From old paragraph 1.67 edited.

The paragraph that refers to the similar purpose customs officials and tax administrations may have in examining the reported values of cross-border controlled transactions was eliminated. It was added a paragraph that stresses



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It was added a paragraph that emphasizes the assertion that a higher price paid for the goods increases the deductibility of the costs to the importing country and also increases the income to the seller in the exporting country.



Chapter II, Section 1 – 2

By: Jaime Heredia – PricewaterhouseCoopers

Chapter II Transfer pricing methods

Part I: Introduction

- a) Selection of the most appropriate transfer pricing method to the circumstances of the case

2.1 Based on first two sentences of old paragraph 1.68, edited; rest of paragraph newly added.

Basically, the most relevant idea in the added paragraph is indicating that to perform a correct selection of a transfer pricing method needs to be taken into account weaknesses and strengths of each of the methods recognized by the OECD, the nature of the particular transaction in determined in functional analysis, and information available as well as the comparability and the adjustments made.

2.2 Based on old paragraph 2.49, edited

This paragraph adds a very important point which refers to the preference in the selection of methods. It indicates with emphasis that traditional transactional methods as well as profit split methods can be used in an equally reliable manner. This is one of the most transcendent changes of the whole revision to the three chapters.

2.3 New

This new paragraph makes reference to the cases when transactional profit splits methods are found to be more appropriate than traditional transaction methods. It emphasize the use of profit split methods when there is no or limited publicly available reliable gross margin information on third parties, and in these cases the use of traditional transactional methods might be difficult to apply.

2.4 Based on seventh and eighth sentences of old paragraph 3.2, edited.

From this paragraph it was removed all the introduction that addressed the use of transactional profit split methods and now it focuses only in the idea that these methods should not be applied automatically simply because there are difficulties in obtaining data.

2.5 Based on old paragraph 3.3, edited.

The edition of this paragraph is based on the idea that refers to the application of the arm's length principle based on a comparison of price, margin or profits from particular controlled transactions



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with those from comparable transactions between independent enterprises. It emphasizes that transactional profit split method is based on an approximation of the division of profits.

2.6 Based on old paragraph 3.4, edited

To this paragraph it was just added a sentence that make reference to those under taxing enterprises that are more successful than average.

2.7 New

This paragraph states that the process of selecting a transfer pricing method should be based on a typical search process and that there is no need to analyze in depth each one of the methods. It make reference to paragraphs 2.1 and 3.5.

2.8 Based on fourth to sixth sentences of old paragraph 1.68 edited.

To this paragraph there were added some sentences that make reference to the use of other methods different than those recognized in the OECD Guidelines. It is stated that the selection of those methods should be supported by a strong explanation of why OECD recognized methods were regarded as non-appropriate.

2.9 From old paragraph 1.70, third sentence of old paragraph 1.68 inserted as new second sentence in this paragraph

The edition of this paragraph consists in moving the sentences "Tax administrations should hesitate from making minor or marginal adjustments" which originally was placed in paragraph 1.68 and is now stated in this paragraph 2.9.

b) Use of more than one method.

2.10 Based on old paragraph 1.69, edited

The edition of this paragraph consists in adding the sentence "(...) for given transaction (or set of transactions that are appropriately aggregated following the standard described at paragraph 3.9)", with the only purpose to give emphasize to the original sentence. It also makes reference to paragraphs 3.57 – 3.58 at the end of this same paragraph.

2.11 New.

This new paragraph states that the purpose of using of a secondary method is to identify usual outcomes that might suggest the need to further review.

Part II: Traditional transaction methods



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To be inserted: content of existing Chapter II of the TPG; paragraphs 2.1 to 2.48 will be renumbered 2.12 to 2.59 and cross-references will be updated accordingly.

To be noted: old paragraph 2.49 was transferred to 2.2.



Chapter II, Section A – B

By: Alejandro Calderón – Capín, Calderón, Ramírez y Gutiérrez-Aspe, S.C.

Chapter II: Transfer Pricing Methods

Part I: Introduction

A.

2.1 The following must be added at the end of the paragraph:

“... and paragraph 2.8 for application of other methods” in order to maintain clear the possibility to apply methods not described in the Guidelines.

2.2 to 2.6. Agree

2.7. We agree that the selection of the most appropriate method does not mean that all or more than one transfer pricing methods should be analyzed in depth or tested. We suggest including the phrase “more than one” in the text to make it clearer.

2.8 to 2.9 agree

B.

2.10 We agree that it is not necessary to perform analysis under more than one method.

2.1.. We agree that a secondary method is only used to confirm that the primary method is the most appropriate method.



Chapter II, Section 3 C – D

By: José Luis Velasco – Oliver Consulting, S.C.

I agree with everything therefore no additional comments would be provided.



Chapter III, Section B – C

By: Yoshio Uehara – Chávez, Ruiz, Zamarripa y Cía., S.C.

Chapter III

Section B – Timing issues in comparability

iii) Valuation highly uncertain at the outset and unpredictable events

3.71 ...how to take account in the transfer pricing analysis of future events that were unpredictable at the time of the testing of a controlled transaction... The question should be resolved, both by taxpayers and tax administrations, by reference to what independent enterprises would have done in comparable circumstances...

If for the taxpayer the situation is uncertain, how would be possible to find comparable information of similar circumstances, such information will be not available, or if it is, it will be much more subjective and uncertain. The comparison should not provide reliable results.

Section C – Compliance issues

3.80 ...Taxpayers and tax administrations should exercise judgment to determine whether particular comparables are reasonably reliable or whether there is a need to search for more reliable ones.

Based on Mexican experience, it is highly possible that tax administrations will judge that there is a need of more reliable comparables. The costs and administration burden that should be borne by the taxpayers (mentioned in 3.79) will increase. Of course this should be analyzed on a case by case basis; however the guidelines should be more specific on the tax administration judgment faculty.

3.82 ...pragmatic solutions may be appropriate...

The guidelines should be more specific with respect to these pragmatic solutions.



Chapter III, Section A, i-iii

By: Teresa Quiñones – KPMG, Cárdenas Dosal, S.C.

3.2. A more detailed definition of “exhaustive” search of all possible sources of comparison might need to be defined. Large and medium multinational companies might not be able to conduct “exhaustive” searches for all companies and transactions. Paragraph 3.81 indicates that it does make sense to devote a significant amount of time for specific companies to document (including preparing a functional analysis each year) insignificant or immaterial transactions. The Guidelines need to be reviewed and analyzed as a whole instead of reading specific paragraphs separately. This paragraph indicates that an exhaustive search will need to be conducted; paragraph 3.81 indicates that it might not make sense to devote the same amount of time to document all transactions, and paragraph 5.28 indicates that a cost-benefit analysis needs to be taken into account for documentation purposes.

3.3. It is too general. It will not make any change if the paragraph is deleted. It should be clarified what should be the case for planning and documentation and whether the analysis should be contemporaneous with the transaction or with the tax return. That fact will imply differences in that information that will be available for purposes of the analysis.

3.9. It might be appropriate to include more detail examples, specifically referring to that included in the last sentence of the paragraph. Transfer pricing could be quite general and that example is too general.

3.18. Consider whether the tested party is selected when using the cost plus method and the resale price method as the methods directly imply the analysis from one side of the transaction and, therefore, the tested party in those methods is implicit in the method to be used.

3.19. The paragraph should also consider those cases in which functional and financial information of the non-tested party is not available (e.g., tested party is the subsidiary and the counterparty in the transaction is the headquarter or corporation, specifically when the transaction might not be material for the corporation).

3.22. It should be indicated whether specific financials should be prepared in local GAAP for purposes of using the foreign entity as the tested party in the analysis. For example: the Brazilian company uses a U.S. sub as tested party, should the financial information of the U.S. entity be prepared in U.S. or Brazilian GAAP? Or should the U.S. entity prepare its financials in U.S. GAAP, in Brazilian GAAP or both? However should tax authorities reconcile this paragraph with paragraph 5.28 of the OECD Transfer Pricing Guidelines.



Chapter III, Section A, iv – v

By: Jaime Zaga – Horwath, Castillo Miranda S.C.

iv) Comparable uncontrolled transactions

a) In general

3.24 The same definition of uncontrolled transactions is presented as in the preceding guidelines.

3.25 The use of the information on controlled transactions is limited; it is suggested only in the risk assessment phase, but they are irrelevant to sustain a transfer pricing policy for the taxpayer or to make adjustments on the part of the authorities.

3.26 The guidelines now include the presence of minority shareholders, who may be a determining factor so that the transactions comply with the arm's-length principle; however, this does not happen in every case. The guidelines are enhanced by considering this type of situation, which should be taken into account in the functional analysis.

b) Internal comparables

3.27 The advantages of using internal comparables is described in greater detail than in paragraph

3.5. There is a tendency to prefer this type of comparable, given its advantages in terms of costs and the fact that it shows more detailed information.

3.28 Despite the advantages of the internal comparables, the five comparability factors must always be fulfilled in the same way as for the external comparables, and it must also be possible to make certain adjustments to improve the comparability.

c) External comparables and sources of information

3.29 For the first time the sources of information used to obtain comparables is mentioned, particularly commercial databases, comparables from other countries and information undisclosed to taxpayers.

1. Databases

3.30 The commercial databases are mentioned as one of the primary sources of information, but at the same time certain points which should be taken into account are indicated, such as: that the information is not available in every country, the amount of information is different, as well as the type of information, and not all the databases have the same level of detail in the information. Furthermore, the databases present the result of the companies and information on transactions with third parties is very rare.



3.31 The databases should be used objectively and to identify reasonably reliable comparable information; however, it is considered to be unnecessary if internal comparables are available.

3.32 It is established that the information from a database must be refined with other sources, while also preferring the quality over the quantity of the information.

3.33 Regarding the use of private databases, it should be taken into account that the authorities may request access to them.

2. Foreign source or non-domestic comparables

3.34 The possibility of using comparables from other nations is established, provided that the five comparability factors are fulfilled; this practice should be considered on a case-by-case basis, not as a general rule.

3. Information undisclosed to taxpayers

3.35 The preceding paragraph on the use of information which the tax authorities have, and which may be inaccessible to taxpayers, is edited.

d) Use of non-transactional third party data

3.36 The discussion on the use of segmented information is expanded. This type of information is preferred because it provides better results than aggregated information. However, the accuracy of the information should be taken into account and whether it is sufficient to provide reliable information and results.

e) Limitations in available comparables

3.37 It is established that comparables are not always perfect; the decision regarding the best comparables will be based on the specific facts and circumstances of each case and the effects expected due to the loss of comparability.

3.38 This paragraph takes up the importance of the functional analysis and the selection of the best method by considering the available information.

v) Selecting or rejecting potential comparables

3.39 It is established that there are two forms of identifying comparables.

3.40 The first way to obtain comparables is known as "Additive"; it is based on results, but without losing objectivity and should therefore be transparent, systematic and repeatable. It is frequently used, mainly in the identification of internal comparables.



3.41 The second form is known as "Deductive", and is applied when a database is available, using several companies that operate in the same market; however, this form of obtaining comparables is not appropriate for all cases or for all methods.

3.42 The most commonly used quantitative criteria are described:

- Volumes of sales, size of assets, number of employees, among others,
- Value of intangibles,
- Value of exports,
- Value of inventories (as the case may be),
- Other factors such as companies beginning operations, in bankruptcy and others which may affect the comparability.

3.43 The Deductive form is more reproducible and transparent than the Additive form, but depends more on the quality of the information sources.

3.44 No preference is established for either of the two forms. It is suggested that the decision should be made on a case-by-case basis, but both forms may be used to improve the search for comparables with better results.

3.45 It is mentioned that the search process for comparables is the most critical aspect of the comparability analysis and should be transparent, systematic and repeatable, which is crucial both for taxpayers and tax authorities.



Chapter III, Section A, vi - vii

By: David Cárdenas – Deloitte – Galaz, Yamazaki, Ruiz-Urquiza, S.C.

Chapter III - Section A vi) and vii)

vi) Comparability adjustments

3.46 A comment in general to this section is the need to clarify whether the comparability adjustments can only be applied to third parties data or they may be also used to adjust the tested party information.

a) Different types of comparability adjustments

3.47 No additional comments.

3.48 We welcome the fact that comparability adjustments should be performed only to the extent they eliminate differences and not on a routine basis.

b) Purpose of comparability adjustments

3.49 Some examples on how the purpose and quality of the information affect the reliability of the comparability adjustments can be helpful.

3.50 As said in the paragraph, many or too sophisticated adjustments may yield to rule out a potential comparable transaction, but more emphasis on the availability of reliable information should be considered.

3.51 No further comments.

c) Reliability of the adjustment performed

3.52 We welcome the notion that every adjustment should have the same level of certainty or it might be better not to use it at all.

d) Documenting and testing comparability adjustments

3.53 No further comments.

vii) Arm's length range

a) In general

3.54 No further comments.

3.55 No further comments.

3.56 We agree on the inclusion of considering statistical tools using central tendency to resolve not adjustable differences, but further insight may be needed to determine what a "sizeable number of observations" is.

3.57 No further comments.



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- 3.58 No additional comments.
- 3.59 No additional comments.
- 3.60 This paragraph is confusing since no more insight is provided to determine the most suitable point to perform an adjustment is.
- 3.61 Same comments as in paragraph 3.56 only when comparability defects are present in all the used transactions. Additionally, this paragraph provides a good alternative when it is not possible to distinguish among the various pints in a range as stated in paragraph 3.60.
- b) Extreme results: comparability considerations
- 3.62 The idea of examining extreme results is welcome, especially if they arise from some unnoticed key comparability factors.
- 3.63 We agree on considering that loss-making transactions should not be ruled out of a sample of comparable transactions, once is determined that it fulfills the necessary comparability conditions. Nevertheless, a deeper analysis is needed where low risks activities can sustain losses and how much time is reasonable from a third party perspective.
- 3.64 No additional comments.
- 3.65 No additional comments.



Appendix I

By: Alejandro Cervantes – Ernst & Young (Mexico)

Comments in connection to Annex I to Chapter II, Part III: Different measures of profits when applying a Transactional Profit Split Method

In my opinion, I agree with the simple and brief example of the application of the Transactional Profit Split Method (hereinafter “TPSM”), but merely as a Guideline, because in theory if a reader reviews the example, may think that the application of the TPSM is very easy and in the real world it is the most difficult Transfer Pricing Method to apply because of many circumstances.

I think it will be very helpful if the example also mentions some of the circumstances that the companies must have in order to apply the TPSM, as for example:

1. How to join/unify the financial numbers of the controlled transaction in analysis to make it reasonable and obtain the combined operating profit.
2. How to separate any other transaction that will not take part of the controlled transaction in analysis and exclude it from the combined operating profit.
3. Some guidance on what to do when it is very difficult to obtain the combined operating profit only for the controlled transaction in analysis.
4. More guidance on what to do when the different exchange used by the companies involved in the controlled transaction in analysis at the moment of obtaining the combined operating profit.
5. Some guidance on what to do when it is very difficult to obtain the sales/expenses related to the intangible asset.

As a conclusion, as a Guideline, this Annex provides a good example but the reader should understand that it is a simple example of the application of the TPSM and that there are many financial and economic circumstances to consider before applying this Transfer Pricing Method.



Appendix II

By: Miguel Angel Freige – Auren

We have gone through the three examples comprised in the OECD comments with regard to Annex II, Chapter II, Part III which refers to the gross profit and net profit margins sensitivity and in general terms, we agree to what item 2 says, in practice, when applying the transactional net margin method, it is required to focus on the comparability of the functions performed rather than in the features of the product.

Based upon the above a Functional Analysis must be a thorough diagnosis of the activities, functions and risks borne by an enterprise in contrast to the comparable entities that were chosen. The cases under analysis are not intended to become guidelines in order to choose a method; in fact, we just want to provide an idea on how the transactional net margin method can be applied.

We think that more than being examples or academic cases, they have much to do with reality. They are, as we have said, guidelines in order to get to know how adjustments arising from marketing expenses in excess, from determining obsolescence risks could be made. In addition, it is included how adjustments can be calculated when an enterprise is not working at full capacity. However, these kinds of analyses shall depend upon the quality of information provided by the tested party and the comparable entities.

First example shows what happens when a distributor performs more complex marketing functions than those marketing functions carried out by the comparable party :

MARKETING FUNCTION OF A DISTRIBUTOR	Case 1 The distributor performs a limited marketing function	Case 2 The distributor performs a more significant marketing function
Sales of product (for illustration purposes, assume both sell the same volume of the same product on the same market at the same price)	1,000	1,000
Purchase price from manufacturer taking account of the significance of the marketing function in accordance to the functional analysis	600	480 *
Gross Margin	400 (40%)	520 (52%)
Marketing Expenses	50 (5%)	150 (15%)
Other Expenses (overheads)	300 (30%)	300 (30%)
Net Profit Margin	50 (5%)	70 (7%)

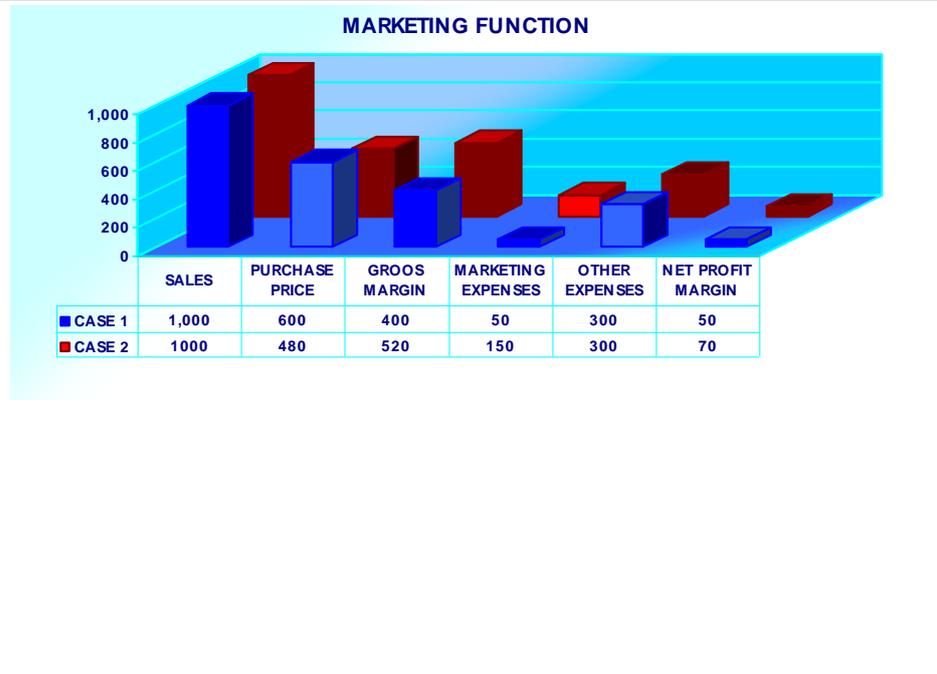
(*) Assume that in this case the difference of 120 in transaction price corresponds to the difference in the extent and complexity of the marketing function performed by the distributor (additional expense of 100 plus remuneration of the function of the distributor)



<p>As it is shown, in Case 2 Distributor</p>	
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has to incur in a higher marketing expense to publicize the product. This is because the price from the manufacturer is lower than the one offered to the comparable party



If we tried to compare the marketing expense in excess by including it in the manufacturer price (\$480 + \$100), this is, only the excess contrasted to the comparable party, we would get the following result:

MARKETING FUNCTION OF A DISTRIBUTOR	Case 1 The distributor performs a limited marketing function	Case 2 The distributor performs a more significant marketing function
Sales of product (for illustration purposes, assume both sell the same volume of the same product on the same market at the same price)	1,000	1,000
Purchase price from manufacturer taking account of the significance of the marketing function in accordance to the functional analysis	600	580 *
Gross Margin	400 (40%)	420 (42%)
Marketing Expenses	50 (5%)	50 (5%)
Other Expenses (overheads)	300 (30%)	300 (30%)
Net Profit Margin	50 (5%)	70 (7%)

* Los gastos en exceso de Mercadotecnia \$100.00

Gross margin would be more reasonable. This is 42%. Nonetheless, these adjustments may be applied provided that the comparable party has not included in the product price significant marketing expenses.

In the second example we can see that the net profit margins are less sensitive to the differences in the risk levels than the gross profit margins depending upon the particular circumstances and the effect of the risk levels differences within the cost and revenue structures of the comparable parties in contrast to the tested party.

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RISK OF OBSOLESCENCE	Case 1 The distributor does not assume the risk of obsolescence of products because it benefits from a "buy back" clause whereby all unsold inventory is purchased back the manufacturer	Case 2 The distributor performs more significant marketing
Sales of product (for illustration purposes, assume both sell the same volume of the same product on the same market at the same price)	1,000	1,000
Purchase price from manufacturer taking account of the obsolescence risk in accordance with the functional analysis	700	640 *
Gross Margin	300 (30%)	360 (36%)
Loss on Obsolete Inventory	0	50 (5%)
Other Expenses (overheads)	250 (25%)	250 (25%)
Net Profit Margin	50 (5%)	60 (6%)

(*) Assume that in this case the difference of 60 in transaction price corresponds to the difference in the allocation of the obsolescence risk between the manufacturer and the distributor (additional loss estimated 50 plus remuneration of the risk of the distributor), i.e. it is the price for the contractual "buy back" clause



If the transaction in Case Two is carried out according to Case One and the difference in the risk level of the comparable third party is not taken into account, then, the risk of error in the gross profit margin may be 6%

OBSOLESCENCE RISK

	SALES	PURCHASE PRICE	GROSS MARGIN	LOSS ON OBSOLETE	OTHER EXPENSES	NET PROFIT MARGIN
■ CASE 1	1,000	700	300	0	250	50
■ CASE 2	1000	640	360	50	250	60

On the contrary if the cost of the loss for inventory obsolescence adjustment was included in the manufacturer purchase price, the difference in the gross margin would be 1% as it is shown in the following table:



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RISK OF OBSOLESCENCE	Case 1 The distributor does not assume the risk of obsolescence of products because it benefits from a "buy back" clause whereby all unsold inventory is purchased back the manufacturer	Case 2 The distributor performs a more significant marketing function
Sales of product (for illustration purposes, assume both sell the same volume of the same product on the same market at the same price)	1,000	1,000
Purchase price from manufacturer taking account of the obsolescence risk in accordance with the functional analysis	700	690 *
Gross Margin	300 (30%)	310 (31%)
Loss on Obsolete Inventory	0	0
Other Expenses (overheads)	250 (25%)	250 (25%)
Net Profit Margin	50 (5%)	60 (6%)

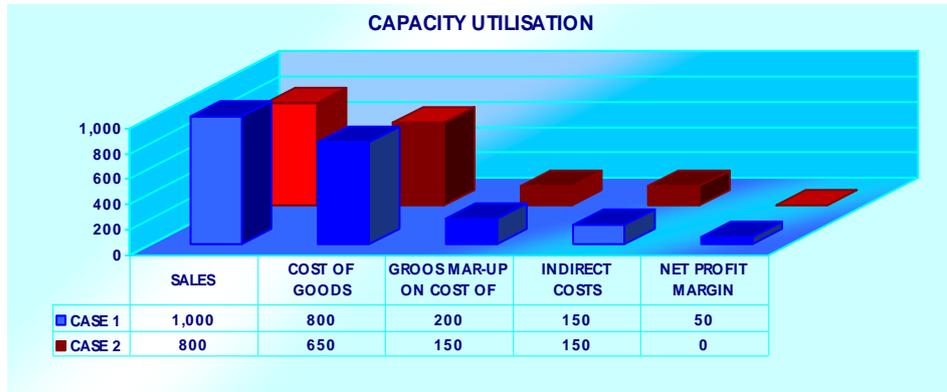
* Sumando al precio del fabricante la pérdida por obsolescencia

Some Business experts have correctly stated that the Net Profit Margin is less sensitive to differences in volume, extension and complexity in functions and in operating expenses than the cost plus and resale price methods are. This is the same when talking about capacity that has not been used, because the way in which the indirect fixed costs are absorbed (fixed manufacturing and distribution costs) would affect the net profit margin and not the gross profit margin or mark-up if there were not differences in the sales price. According to the third example it could be very significant to know such variables:

In monetary units (m.u.)	Case 1 The manufacturer operates in full capacity: 1,000 units per year	Case 2 The manufacturer operates in excess capacity i.e. only manufactures 80% of what it could manufacture in full capacity: 800 units per year
Sales of manufactured products (for illustration purposes, assume both manufacturers have the same total capacity, and that they both manufacture and sell the same product on the same market which have the same price of m.u. per manufactured product) (*)	1,000	800
Cost of goods sold: direct cost plus standard allocation of indirect manufacturing costs. (for illustration purposes, assume both manufacturers have the same variable cost of goods sold per manufactured unit, i.e. 0.75 m.u. per manufactured product, and fixed personal costs of 50).	Variable : 750 Fixed: 50 Total: 800	Variable : 600 Fixed: 50 Total: 650
Gross mark-up on cost of goods sold	200 (25%)	150 (23%)
Indirect costs (for illustration purposes, assume both manufacturers have the same indirect costs)	150 (15%)	150 (15%)
Net Profit Margin	50 (5%)	Breakeven

(*) This assume that the arm's length price of the manufactured products is not affected by the manufacturer's capacity utilisation.

The main issue is to be able to determine the transaction below its full capacity, both, from the tested party and the comparable ones. But in practice this is too hard to get.



In Mexico, due to the swine flu as well as for the crisis arising from the recession in the United States, in 2009, the adjustments coming from installed capacity, mainly with regard to the hotel industry shall be significant.

Finally we can conclude that the examples provided herein are not more than practical guidelines in order to substantiate the adjustments and to propose the best method. As always, the results shall depend upon the quality of the available information from both, the tested party and the comparable entities.

A thorough Functional Analysis shall be the best tool in order to make the abstract and subjective part of transfer prices become more understandable.

Appendix III

By: Jimmy Cruz – Ernst & Young (Mexico)

I really welcome the inclusion of examples as to how the working capital adjustments should be applied and do not have additional comments on this regard.



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