



ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT



## REVIEW OF COMPARABILITY AND OF PROFIT METHODS:

### REVISION OF CHAPTERS I-III OF THE TRANSFER PRICING GUIDELINES

22 July 2010



CENTRE FOR TAX POLICY AND ADMINISTRATION

## **FOREWORD**

This Report was approved by the Committee on Fiscal Affairs on 22 June 2010 and by the OECD Council on 22 July 2010. The Recommendation of the Council on the Determination of Transfer Pricing between Associated Enterprises [C(95)126/FINAL] was amended on 22 July 2010 to take account of the attached revision of Chapters I-III and concomitant addition of a new Chapter IX to the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations.

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*Note: Annex II to Chapter II contains an example of application of the residual profit split method which was in the pre-existing Transfer Pricing Guidelines and was renumbered upon publication of the 2010 Transfer Pricing Guidelines.*

## Chapter I

### The Arm's Length Principle

#### A. Introduction

1.1 This Chapter provides a background discussion of the arm's length principle, which is the international transfer pricing standard that OECD member countries have agreed should be used for tax purposes by MNE groups and tax administrations. The Chapter discusses the arm's length principle, reaffirms its status as the international standard, and sets forth guidelines for its application.

1.2 When independent enterprises transact with each other, the conditions of their commercial and financial relations (*e.g.* the price of goods transferred or services provided and the conditions of the transfer or provision) ordinarily are determined by market forces. When associated enterprises transact with each other, their commercial and financial relations may not be directly affected by external market forces in the same way, although associated enterprises often seek to replicate the dynamics of market forces in their transactions with each other, as discussed in paragraph 1.5 below. Tax administrations should not automatically assume that associated enterprises have sought to manipulate their profits. There may be a genuine difficulty in accurately determining a market price in the absence of market forces or when adopting a particular commercial strategy. It is important to bear in mind that the need to make adjustments to approximate arm's length transactions arises irrespective of any contractual obligation undertaken by the parties to pay a particular price or of any intention of the parties to minimize tax. Thus, a tax adjustment under the arm's length principle would not affect the underlying contractual obligations for non-tax purposes between the associated enterprises, and may be appropriate even where there is no intent to minimize or avoid tax. The consideration of transfer pricing should not be confused with the consideration of problems of tax fraud or tax avoidance, even though transfer pricing policies may be used for such purposes.

1.3 When transfer pricing does not reflect market forces and the arm's length principle, the tax liabilities of the associated enterprises and the tax revenues of the host countries could be distorted. Therefore, OECD member countries have agreed that for tax purposes the profits of associated enterprises may be adjusted as necessary to correct any such distortions and thereby ensure that the arm's length principle is satisfied. OECD member countries consider that an appropriate adjustment is achieved by establishing the conditions of the commercial and financial relations that they would expect to find between independent enterprises in comparable transactions under comparable circumstances.

1.4 Factors other than tax considerations may distort the conditions of commercial and financial relations established between associated enterprises. For example, such enterprises may be subject to conflicting governmental pressures (in the domestic as well as foreign country) relating to customs valuations, anti-dumping duties, and exchange or price controls. In addition, transfer price distortions may be caused by the cash flow requirements of enterprises within an MNE group. An MNE group that is publicly held may feel pressure from shareholders to show high profitability at the parent company level, particularly if shareholder reporting is not undertaken on a consolidated basis. All of these factors may affect transfer prices and the amount of profits accruing to associated enterprises within an MNE group.

1.5 It should not be assumed that the conditions established in the commercial and financial relations between associated enterprises will invariably deviate from what the open market would demand. Associated enterprises in MNEs sometimes have a considerable amount of autonomy and can often bargain with each other as though they were independent enterprises. Enterprises respond to economic situations arising from market conditions, in their relations with both third parties and associated enterprises. For example, local managers may be interested in establishing good profit records and therefore would not want to establish prices that would reduce the profits of their own companies. Tax administrations should keep these considerations in mind to facilitate efficient allocation of their resources in selecting and conducting transfer pricing examinations. Sometimes, it may occur that the relationship between the associated enterprises may influence the outcome of the bargaining. Therefore, evidence of hard bargaining alone is not sufficient to establish that the transactions are at arm's length.

## **B. Statement of the arm's length principle**

### ***B.1 Article 9 of the OECD Model Tax Convention***

1.6 The authoritative statement of the arm's length principle is found in paragraph 1 of Article 9 of the OECD Model Tax Convention, which forms the basis of bilateral tax treaties involving OECD member countries and an increasing number of non-member countries. Article 9 provides:

[Where] conditions are made or imposed between the two [associated] enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.

By seeking to adjust profits by reference to the conditions which would have obtained between independent enterprises in comparable transactions and comparable circumstances (*i.e.* in “comparable uncontrolled transactions”), the arm's length principle follows the approach of treating the members of an MNE group as operating as separate entities rather than as inseparable parts of a single unified business. Because the separate entity approach treats the members of an MNE group as if they were independent entities, attention is focused on the nature of the transactions between those members and on whether the conditions thereof differ from the conditions that would be obtained in comparable uncontrolled transactions. Such an analysis of the controlled and uncontrolled transactions, which is referred to as a “comparability analysis”, is at the heart of the application of the arm's length principle. Guidance on the comparability analysis is found in Section D below and in Chapter III.

1.7 It is important to put the issue of comparability into perspective in order to emphasise the need for an approach that is balanced in terms of, on the one hand, its reliability and, on the other, the burden it creates for taxpayers and tax administrations. Paragraph 1 of Article 9 of the OECD Model Tax Convention is the foundation for comparability analyses because it introduces the need for:

- A comparison between conditions (including prices, but not only prices) made or imposed between associated enterprises and those which would be made between independent enterprises, in order to determine whether a re-writing of the accounts for the purposes of calculating tax liabilities of associated enterprises is authorised under Article 9 of the OECD Model Tax Convention (see paragraph 2 of the Commentary on Article 9); and
- A determination of the profits which would have accrued at arm's length, in order to determine the quantum of any re-writing of accounts.

1.8 There are several reasons why OECD member countries and other countries have adopted the arm's length principle. A major reason is that the arm's length principle provides broad parity of tax treatment for members of MNE groups and independent enterprises. Because the arm's length principle puts associated and independent enterprises on a more equal footing for tax purposes, it avoids the creation of tax advantages or disadvantages that would otherwise distort the relative competitive positions of either type of entity. In so removing these tax considerations from economic decisions, the arm's length principle promotes the growth of international trade and investment.

1.9 The arm's length principle has also been found to work effectively in the vast majority of cases. For example, there are many cases involving the purchase and sale of commodities and the lending of money where an arm's length price may readily be found in a comparable transaction undertaken by comparable independent enterprises under comparable circumstances. There are also many cases where a relevant comparison of transactions can be made at the level of financial indicators such as mark-up on costs, gross margin, or net profit indicators. Nevertheless, there are some significant cases in which the arm's length principle is difficult and complicated to apply, for example, in MNE groups dealing in the integrated production of highly specialised goods, in unique intangibles, and/or in the provision of specialised services. Solutions exist to deal with such difficult cases, including the use of the transactional profit split method described in Chapter II, Part III of these Guidelines in those situations where it is the most appropriate method in the circumstances of the case.

1.10 The arm's length principle is viewed by some as inherently flawed because the separate entity approach may not always account for the economies of scale and interrelation of diverse activities created by integrated businesses. There are, however, no widely accepted objective criteria for allocating the economies of scale or benefits of integration between associated enterprises. The issue of possible alternatives to the arm's length principle is discussed in Section C below.

1.11 A practical difficulty in applying the arm's length principle is that associated enterprises may engage in transactions that independent enterprises would not undertake. Such transactions may not necessarily be motivated by tax avoidance but may occur because in transacting business with each other, members of an MNE group face different commercial circumstances than would independent enterprises. Where independent enterprises seldom undertake transactions of the type entered into by associated enterprises, the arm's length principle is difficult to apply because there is little or no direct evidence of what conditions would have been established by independent enterprises. The mere fact that a transaction may not be found between independent parties does not of itself mean that it is not arm's length.

1.12 In certain cases, the arm's length principle may result in an administrative burden for both the taxpayer and the tax administrations of evaluating significant numbers and types of cross-border transactions. Although associated enterprises normally establish the conditions for a transaction at the time it is undertaken, at some point the enterprises may be required to demonstrate that these are consistent with the arm's length principle. (See discussion of timing and compliance issues at Sections B and C of Chapter III and at Chapter V on Documentation). The tax administration may also have to engage in this verification process perhaps some years after the transactions have taken place. The tax administration would review any supporting documentation prepared by the taxpayer to show that its transactions are consistent with the arm's length principle, and may also need to gather information about comparable uncontrolled transactions, the market conditions at the time the transactions took place, etc., for numerous and varied transactions. Such an undertaking usually becomes more difficult with the passage of time.

1.13 Both tax administrations and taxpayers often have difficulty in obtaining adequate information to apply the arm's length principle. Because the arm's length principle usually requires taxpayers and tax administrations to evaluate uncontrolled transactions and the business activities of independent enterprises, and to compare these with the transactions and activities of associated enterprises, it can demand a

substantial amount of data. The information that is accessible may be incomplete and difficult to interpret; other information, if it exists, may be difficult to obtain for reasons of its geographical location or that of the parties from whom it may have to be acquired. In addition, it may not be possible to obtain information from independent enterprises because of confidentiality concerns. In other cases information about an independent enterprise which could be relevant may simply not exist, or there may be no comparable independent enterprises, *e.g.* if that industry has reached a high level of vertical integration. It is important not to lose sight of the objective to find a reasonable estimate of an arm's length outcome based on reliable information. It should also be recalled at this point that transfer pricing is not an exact science but does require the exercise of judgment on the part of both the tax administration and taxpayer.

## ***B.2 Maintaining the arm's length principle as the international consensus***

1.14 While recognizing the foregoing considerations, the view of OECD member countries continues to be that the arm's length principle should govern the evaluation of transfer prices among associated enterprises. The arm's length principle is sound in theory since it provides the closest approximation of the workings of the open market in cases where property (such as goods, other types of tangible assets, or intangible assets) is transferred or services are rendered between associated enterprises. While it may not always be straightforward to apply in practice, it does generally produce appropriate levels of income between members of MNE groups, acceptable to tax administrations. This reflects the economic realities of the controlled taxpayer's particular facts and circumstances and adopts as a benchmark the normal operation of the market.

1.15 A move away from the arm's length principle would abandon the sound theoretical basis described above and threaten the international consensus, thereby substantially increasing the risk of double taxation. Experience under the arm's length principle has become sufficiently broad and sophisticated to establish a substantial body of common understanding among the business community and tax administrations. This shared understanding is of great practical value in achieving the objectives of securing the appropriate tax base in each jurisdiction and avoiding double taxation. This experience should be drawn on to elaborate the arm's length principle further, to refine its operation, and to improve its administration by providing clearer guidance to taxpayers and more timely examinations. In sum, OECD member countries continue to support strongly the arm's length principle. In fact, no legitimate or realistic alternative to the arm's length principle has emerged. Global formulary apportionment, sometimes mentioned as a possible alternative, would not be acceptable in theory, implementation, or practice. (See Section C, immediately below, for a discussion of global formulary apportionment.)

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

### ***C.1 Background and description of approach***

1.16 Global formulary apportionment has sometimes been suggested as an alternative to the arm's length principle as a means of determining the proper level of profits across national taxing jurisdictions. The approach has not been applied as between countries although it has been attempted by some local taxing jurisdictions.

1.17 Global formulary apportionment would allocate the global profits of an MNE group on a consolidated basis among the associated enterprises in different countries on the basis of a predetermined and mechanistic formula. There would be three essential components to applying global formulary apportionment: determining the unit to be taxed, *i.e.* which of the subsidiaries and branches of an MNE group should comprise the global taxable entity; accurately determining the global profits; and establishing the formula to be used to allocate the global profits of the unit. The formula would most likely be based on some combination of costs, assets, payroll, and sales.

1.18 Global formulary apportionment should not be confused with the transactional profit methods discussed in Part III of Chapter II. Global formulary apportionment would use a formula that is predetermined for all taxpayers to allocate profits whereas transactional profit methods compare, on a case-by-case basis, the profits of one or more associated enterprises with the profit experience that comparable independent enterprises would have sought to achieve in comparable circumstances. Global formulary apportionment also should not be confused with the selected application of a formula developed by both tax administrations in cooperation with a specific taxpayer or MNE group after careful analysis of the particular facts and circumstances, such as might be used in a mutual agreement procedure, advance pricing agreement, or other bilateral or multilateral determination. Such a formula is derived from the particular facts and circumstances of the taxpayer and thus avoids the globally pre-determined and mechanistic nature of global formulary apportionment.

## ***C.2 Comparison with the arm's length principle***

1.19 Global formulary apportionment has been promoted as an alternative to the arm's length principle by advocates who claim that it would provide greater administrative convenience and certainty for taxpayers. These advocates also take the position that global formulary apportionment is more in keeping with economic reality. They argue that an MNE group must be considered on a group-wide or consolidated basis to reflect the business realities of the relationships among the associated enterprises in the group. They assert that the separate accounting method is inappropriate for highly integrated groups because it is difficult to determine what contribution each associated enterprise makes to the overall profit of the MNE group.

1.20 Apart from these arguments, advocates contend that global formulary apportionment reduces compliance costs for taxpayers since in principle only one set of accounts would be prepared for the group for domestic tax purposes.

1.21 OECD member countries do not accept these propositions and do not consider global formulary apportionment a realistic alternative to the arm's length principle, for the reasons discussed below.

1.22 The most significant concern with global formulary apportionment is the difficulty of implementing the system in a manner that both protects against double taxation and ensures single taxation. To achieve this would require substantial international coordination and consensus on the predetermined formulae to be used and on the composition of the group in question. For example, to avoid double taxation there would have to be common agreement to adopt the approach in the first instance, followed by agreement on the measurement of the global tax base of an MNE group, on the use of a common accounting system, on the factors that should be used to apportion the tax base among different jurisdictions (including non-member countries), and on how to measure and weight those factors. Reaching such agreement would be time-consuming and extremely difficult. It is far from clear that countries would be willing to agree to a universal formula.

1.23 Even if some countries were willing to accept global formulary apportionment, there would be disagreements because each country may want to emphasize or include different factors in the formula based on the activities or factors that predominate in its jurisdiction. Each country would have a strong incentive to devise formulae or formula weights that would maximise that country's own revenue. 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. There could be tax avoidance to the extent that the components of the relevant formula can be manipulated, *e.g.* by entering into unnecessary financial transactions, by the deliberate location of mobile assets, by requiring that particular companies within an MNE group maintain inventory levels in excess of what normally would be encountered in an uncontrolled company of that type, and so on.

1.24 The transition to a global formulary apportionment system therefore would present enormous political and administrative complexity and require a level of international cooperation that is unrealistic to expect in the field of international taxation. Such multilateral coordination would require the inclusion of all major countries where MNEs operate. If all the major countries failed to agree to move to global formulary apportionment, MNEs would be faced with the burden of complying with two totally different systems. In other words, for the same set of transactions they would be forced to calculate the profits accruing to their members under two completely different standards. Such a result would create the potential for double taxation (or under-taxation) in every case.

1.25 There are other significant concerns in addition to the double taxation issues discussed above. One such concern is that predetermined formulae are arbitrary and disregard market conditions, the particular circumstances of the individual enterprises, and management's own allocation of resources, thus producing an allocation of profits that may bear no sound relationship to the specific facts surrounding the transaction. More specifically, a formula based on a combination of cost, assets, payroll, and sales implicitly imputes a fixed rate of profit per currency unit (*e.g.* dollar, euro, yen) of each component to every member of the group and in every tax jurisdiction, regardless of differences in functions, assets, risks, and efficiencies and among members of the MNE group. Such an approach could potentially assign profits to an entity that would incur losses if it were an independent enterprise.

1.26 Another issue for global formulary apportionment is dealing with exchange rate movements. Although exchange rate movements can complicate application of the arm's length principle they do not have the same impact as for global formulary apportionment; the arm's length principle is better equipped to deal with the economic consequences of exchange rate movements because it requires the analysis of the specific facts and circumstances of the taxpayer. If the formula relies on costs, the result of applying a global formulary apportionment would be that as a particular currency strengthens in one country consistently against another currency in which an associated enterprise keeps its accounts, a greater share of the profit would be attributed to the enterprise in the first country to reflect the costs of its payroll nominally increased by the currency fluctuation. Thus, under a global formulary apportionment, the exchange rate movement in this example would lead to increasing the profits of the associated enterprise operating with the stronger currency whereas in the long run a strengthening currency makes exports less competitive and leads to a downward pressure on profits.

1.27 Contrary to the assertions of its advocates, global formulary apportionment may in fact present intolerable compliance costs and data requirements because information would have to be gathered about the entire MNE group and presented in each jurisdiction on the basis of the currency and the book and tax accounting rules of that particular jurisdiction. Thus, the documentation and compliance requirements for an application of global formulary apportionment would generally be more burdensome than under the separate entity approach of the arm's length principle. The costs of a global formulary apportionment would be further magnified if not all countries could agree on the components of the formula or on the way the components are measured.

1.28 Difficulties also would arise in determining the sales of each member and in the valuation of assets (*e.g.* historic cost versus market value), especially in the valuation of intangible property. These difficulties would be compounded by the existence across taxing jurisdictions of different accounting standards and of multiple currencies. Accounting standards among all countries would have to be conformed in order to arrive at a meaningful measure of profit for the entire MNE group. Of course, some of these difficulties, for example the valuation of assets and intangibles, also exist under the arm's length principle, although significant progress in respect of the latter has been made, whereas no credible solutions have been put forward under global formulary apportionment.

1.29 Global formulary apportionment would have the effect of taxing an MNE group on a consolidated basis and therefore abandons the separate entity approach. As a consequence, global formulary apportionment cannot, as a practical matter, recognize important geographical differences, separate company efficiencies, and other factors specific to one company or sub-grouping within the MNE group that may legitimately play a role in determining the division of profits between enterprises in different tax jurisdictions. The arm's length principle, in contrast, recognizes that an associated enterprise may be a separate profit or loss centre with individual characteristics and economically may be earning a profit even when the rest of the MNE group is incurring a loss. Global formulary apportionment does not have the flexibility to account properly for this possibility.

1.30 By disregarding intra-group transactions for the purpose of computing consolidated profits, global formulary apportionment would raise questions about the relevance of imposing withholding taxes on cross-border payments between group members and would involve a rejection of a number of rules incorporated in bilateral tax treaties.

1.31 Unless global formulary apportionment includes every member of an MNE group, it must retain a separate entity rule for the interface between that part of the group subject to global formulary apportionment and the rest of the MNE group. Global formulary apportionment could not be used to value the transactions between the global formulary apportionment group and the rest of the MNE group. Thus, a clear disadvantage with global formulary apportionment is that it does not provide a complete solution to the allocation of profits of an MNE group unless global formulary apportionment is applied on the basis of the whole MNE group. This exercise would be a serious undertaking for a single tax administration given the size and scale of operations of major MNE groups and the information that would be required. The MNE group would also be required, in any event, to maintain separate accounting for corporations that are not members of the MNE group for global formulary apportionment tax purposes but that are still associated enterprises of one or more members of the MNE group. In fact, many domestic commercial and accountancy rules would still require the use of arm's length prices (*e.g.* customs rules), so that irrespective of the tax provisions a taxpayer would have to book properly every transaction at arm's length prices.

### ***C.3 Rejection of non-arm's-length methods***

1.32 For the foregoing reasons, OECD member countries reiterate their support for the consensus on the use of the arm's length principle that has emerged over the years among member and non-member countries and agree that the theoretical alternative to the arm's length principle represented by global formulary apportionment should be rejected.

## **D. Guidance for applying the arm's length principle**

### ***D.1 Comparability analysis***

#### *D.1.1 Significance of the comparability analysis and meaning of "comparable"*

1.33 Application of the arm's length principle is generally based on a comparison of the conditions in a controlled transaction with the conditions in transactions between independent enterprises. In order for such comparisons to be useful, the economically relevant characteristics of the situations being compared must be sufficiently comparable. To be comparable means that none of the differences (if any) between the situations being compared could materially affect the condition being examined in the methodology (*e.g.* price or margin), or that reasonably accurate adjustments can be made to eliminate the effect of any such differences. In determining the degree of comparability, including what adjustments are necessary to establish it, an understanding of how independent enterprises evaluate potential transactions is required. Detailed guidance on performing a comparability analysis is set forth in Chapter III.

1.34 Independent enterprises, when evaluating the terms of a potential transaction, will compare the transaction to the other options realistically available to them, and they will only enter into the transaction if they see no alternative that is clearly more attractive. For example, one enterprise is unlikely to accept a price offered for its product by an independent enterprise if it knows that other potential customers are willing to pay more under similar conditions. This point is relevant to the question of comparability, since independent enterprises would generally take into account any economically relevant differences between the options realistically available to them (such as differences in the level of risk or other comparability factors discussed below) when valuing those options. Therefore, when making the comparisons entailed by application of the arm's length principle, tax administrations should also take these differences into account when establishing whether there is comparability between the situations being compared and what adjustments may be necessary to achieve comparability.

1.35 All methods that apply the arm's length principle can be tied to the concept that independent enterprises consider the options available to them and in comparing one option to another they consider any differences between the options that would significantly affect their value. For instance, before purchasing a product at a given price, independent enterprises normally would be expected to consider whether they could buy the same product on otherwise comparable terms and conditions but at a lower price from another party. Therefore, as discussed in Chapter II, Part II, the comparable uncontrolled price method compares a controlled transaction to similar uncontrolled transactions to provide a direct estimate of the price the parties would have agreed to had they resorted directly to a market alternative to the controlled transaction. However, the method becomes a less reliable substitute for arm's length transactions if not all the characteristics of these uncontrolled transactions that significantly affect the price charged between independent enterprises are comparable. Similarly, the resale price and cost plus methods compare the gross profit margin earned in the controlled transaction to gross profit margins earned in similar uncontrolled transactions. The comparison provides an estimate of the gross profit margin one of the parties could have earned had it performed the same functions for independent enterprises and therefore provides an estimate of the payment that party would have demanded, and the other party would have been willing to pay, at arm's length for performing those functions. Other methods, as discussed in Chapter II, Part III, are based on comparisons of net profit indicators (such as profit margins) between independent and associated enterprises as a means to estimate the profits that one or each of the associated enterprises could have earned had they dealt solely with independent enterprises, and therefore the payment those enterprises would have demanded at arm's length to compensate them for using their resources in the controlled transaction. Where there are differences between the situations being compared that could materially affect the comparison, comparability adjustments must be made, where possible, to improve the reliability of the comparison. Therefore, in no event can unadjusted industry average returns themselves establish arm's length conditions.

1.36 As noted above, in making these comparisons, material differences between the compared transactions or enterprises should be taken into account. In order to establish the degree of actual comparability and then to make appropriate adjustments to establish arm's length conditions (or a range thereof), it is necessary to compare attributes of the transactions or enterprises that would affect conditions in arm's length transactions. Attributes or "comparability factors" that may be important when determining comparability include the characteristics of the property or services transferred, the functions performed by the parties (taking into account assets used and risks assumed), the contractual terms, the economic circumstances of the parties, and the business strategies pursued by the parties. These comparability factors are discussed in more detail at Section D.1.2 below.

1.37 The extent to which each of these factors matters in establishing comparability will depend upon the nature of the controlled transaction and the pricing method adopted. For a discussion of the relevance of these factors for the application of particular pricing methods, see the consideration of those methods in Chapter II.

### D.1.2 Factors determining comparability

1.38 Paragraph 1.36 refers to five factors that may be important when determining comparability. As part of a comparison exercise, the examination of the five comparability factors is by nature two-fold, *i.e.* it includes an examination of the factors affecting the taxpayer's controlled transactions and an examination of the factors affecting uncontrolled transactions. Both the nature of the controlled transaction and the transfer pricing method adopted (see Chapter II for a discussion of transfer pricing methods) should be taken into account when evaluating the relative importance of any missing piece of information on possible comparables, which can vary on a case-by-case basis. Information on product characteristics might be more important if the method applied is a comparable uncontrolled price method than if it is a transactional net margin method. If it can be reasonably assumed that the unadjusted difference is not likely to have a material effect on the comparability, the uncontrolled transaction at issue should not be rejected as potentially comparable, despite some pieces of information being missing.

#### D.1.2.1 Characteristics of property or services

1.39 Differences in the specific characteristics of property or services often account, at least in part, for differences in their value in the open market. Therefore, comparisons of these features may be useful in determining the comparability of controlled and uncontrolled transactions. Characteristics that may be important to consider include the following: in the case of transfers of tangible property, the physical features of the property, its quality and reliability, and the availability and volume of supply; in the case of the provision of services, the nature and extent of the services; and in the case of intangible property, the form of transaction (*e.g.* licensing or sale), the type of property (*e.g.* patent, trademark, or know-how), the duration and degree of protection, and the anticipated benefits from the use of the property.

1.40 Depending on the transfer pricing method, this factor must be given more or less weight. Among the methods described at Chapter II of these Guidelines, the requirement for comparability of property or services is the strictest for the comparable uncontrolled price method. Under the comparable uncontrolled price method, any material difference in the characteristics of property or services can have an effect on the price and would require an appropriate adjustment to be considered (see in particular paragraph 2.15). Under the resale price method and cost plus method, some differences in the characteristics of property or services are less likely to have a material effect on the gross profit margin or mark-up on costs (see in particular paragraphs 2.23 and 2.41). Differences in the characteristics of property or services are also less sensitive in the case of the transactional profit methods than in the case of traditional transaction methods (see in particular paragraph 2.69). This however does not mean that the question of comparability in characteristics of property or services can be ignored when applying these methods, because it may be that product differences entail or reflect different functions performed, assets used and/or risks assumed by the tested party. See paragraphs 3.18-3.19 for a discussion of the notion of tested party.

1.41 In practice, it has been observed that comparability analyses for methods based on gross or net profit indicators often put more emphasis on functional similarities than on product similarities. Depending on the facts and circumstances of the case, it may be acceptable to broaden the scope of the comparability analysis to include uncontrolled transactions involving products that are different, but where similar functions are undertaken. However, the acceptance of such an approach depends on the effects that the product differences have on the reliability of the comparison and on whether or not more reliable data are available. Before broadening the search to include a larger number of potentially comparable uncontrolled transactions based on similar functions being undertaken, thought should be given to whether such transactions are likely to offer reliable comparables for the controlled transaction.

#### D.1.2.2 Functional analysis

1.42 In transactions between two independent enterprises, compensation usually will reflect the functions that each enterprise performs (taking into account assets used and risks assumed). Therefore, in determining whether controlled and uncontrolled transactions or entities are comparable, a functional analysis is necessary. This functional analysis seeks to identify and compare the economically significant activities and responsibilities undertaken, assets used and risks assumed by the parties to the transactions. For this purpose, it may be helpful to understand the structure and organisation of the group and how they influence the context in which the taxpayer operates. It will also be relevant to determine the legal rights and obligations of the taxpayer in performing its functions.

1.43 The functions that taxpayers and tax administrations might need to identify and compare include, *e.g.* design, manufacturing, assembling, research and development, servicing, purchasing, distribution, marketing, advertising, transportation, financing and management. The principal functions performed by the party under examination should be identified. Adjustments should be made for any material differences from the functions undertaken by any independent enterprises with which that party is being compared. While one party may provide a large number of functions relative to that of the other party to the transaction, it is the economic significance of those functions in terms of their frequency, nature, and value to the respective parties to the transactions that is important.

1.44 The functional analysis should consider the type of assets used, such as plant and equipment, the use of valuable intangibles, financial assets, etc., and the nature of the assets used, such as the age, market value, location, property right protections available, etc.

1.45 Controlled and uncontrolled transactions and entities are not comparable if there are significant differences in the risks assumed for which appropriate adjustments cannot be made. Functional analysis is incomplete unless the material risks assumed by each party have been considered since the assumption or allocation of risks would influence the conditions of transactions between the associated enterprises. Usually, in the open market, the assumption of increased risk would also be compensated by an increase in the expected return, although the actual return may or may not increase depending on the degree to which the risks are actually realised.

1.46 The types of risks to consider include market risks, such as input cost and output price fluctuations; risks of loss associated with the investment in and use of property, plant, and equipment; risks of the success or failure of investment in research and development; financial risks such as those caused by currency exchange rate and interest rate variability; credit risks; and so forth.

1.47 The functions carried out (taking into account the assets used and the risks assumed) will determine to some extent the allocation of risks between the parties, and therefore the conditions each party would expect in arm's length transactions. For example, when a distributor takes on responsibility for marketing and advertising by risking its own resources in these activities, its expected return from the activity would usually be commensurately higher and the conditions of the transaction would be different from when the distributor acts merely as an agent, being reimbursed for its costs and receiving the income appropriate to that activity. Similarly, a contract manufacturer or a contract research provider that takes on no meaningful risk would usually expect only a limited return.

1.48 In line with the discussion below in relation to contractual terms, it may be considered whether a purported allocation of risk is consistent with the economic substance of the transaction. In this regard, the parties' conduct should generally be taken as the best evidence concerning the true allocation of risk. If, for example, a manufacturer sells property to an associated distributor in another country and the taxpayer's contract indicates that the distributor assumes all exchange rate risks in relation to this controlled

transaction, but the transfer price appears in fact to be adjusted so as to insulate the distributor from the effects of exchange rate movements, then the tax administrations may wish to challenge the purported allocation of exchange rate risk for this particular controlled transaction.

1.49 An additional factor to consider in examining the economic substance of a purported risk allocation is the consequence of such an allocation in arm's length transactions. In arm's length transactions it generally makes sense for parties to be allocated a greater share of those risks over which they have relatively more control. For example, suppose that Company A contracts to produce and ship goods to Company B, and the level of production and shipment of goods are to be at the discretion of Company B. In such a case, Company A would be unlikely to agree to take on substantial inventory risk, since it exercises no control over the inventory level while Company B does. Of course, there are many risks, such as general business cycle risks, over which typically neither party has significant control and which at arm's length could therefore be allocated to one or the other party to a transaction. Analysis is required to determine to what extent each party bears such risks in practice.

1.50 When evaluating the extent to which a party to a transaction bears currency exchange and/or interest rate risk, it will ordinarily be necessary to determine whether the taxpayer and/or the MNE group have in place a business strategy which deals with the minimisation or management of such risks. Hedging arrangements, forward contracts, put and call options, swaps, etc., both over-the-counter and special purpose, are common. Members of an MNE may also make use of hedges with other associated enterprises, particularly in the financial sector. If a party that bears a significant market risk declines to hedge its exposure, this may reflect a decision that it will assume the risk, or it may reflect a decision to have the risk hedged by another enterprise within the MNE group. These or other strategies with regard to the hedging or non-hedging of risks, if not accounted for in the transfer pricing analysis, could lead to an inaccurate determination of the profits in a particular jurisdiction.

1.51 In some cases, it has been argued that the relative lack of accuracy of the functional analysis of possible external comparables (as defined in paragraph 3.24) might be counterbalanced by the size of the sample of third party data; however quantity does not make up for poor quality of data in producing a sufficiently reliable analysis. See paragraphs 3.2, 3.38 and 3.46.

#### D.1.2.3 Contractual terms

1.52 In arm's length transactions, the contractual terms of a transaction generally define explicitly or implicitly how the responsibilities, risks and benefits are to be divided between the parties. As such, an analysis of contractual terms should be a part of the functional analysis discussed above. The terms of a transaction may also be found in correspondence/communications between the parties other than a written contract. Where no written terms exist, the contractual relationships of the parties must be deduced from their conduct and the economic principles that generally govern relationships between independent enterprises.

1.53 In transactions between independent enterprises, the divergence of interests between the parties ensures that they will ordinarily seek to hold each other to the terms of the contract, and that contractual terms will be ignored or modified after the fact generally only if it is in the interests of both parties. The same divergence of interests may not exist in the case of associated enterprises, and it is therefore important to examine whether the conduct of the parties conforms to the terms of the contract or whether the parties' conduct indicates that the contractual terms have not been followed or are a sham. In such cases, further analysis is required to determine the true terms of the transaction.

1.54 In practice, information concerning the contractual terms of potentially comparable uncontrolled transactions may be either limited or unavailable, particularly where external comparables provide the

basis for the analysis. The effect of deficiencies in information in establishing comparability will differ depending on the type of transaction being examined and the transfer pricing method applied, see paragraph 1.38. For instance, if the controlled transaction is a licence agreement for the exploitation of intellectual property rights and the transfer pricing method is the comparable uncontrolled price method, information on the key contractual terms of uncontrolled licences, such as the licence's duration, geographic area, exclusivity, etc., can be assumed to be critical to assessing whether such uncontrolled licences provide reliable comparables for the controlled transaction.

#### D.1.2.4 Economic circumstances

1.55 Arm's length prices may vary across different markets even for transactions involving the same property or services; therefore, to achieve comparability requires that the markets in which the independent and associated enterprises operate do not have differences that have a material effect on price or that appropriate adjustments can be made. As a first step, it is essential to identify the relevant market or markets taking account of available substitute goods or services. Economic circumstances that may be relevant to determining market comparability include the geographic location; the size of the markets; the extent of competition in the markets and the relative competitive positions of the buyers and sellers; the availability (risk thereof) of substitute goods and services; the levels of supply and demand in the market as a whole and in particular regions, if relevant; consumer purchasing power; the nature and extent of government regulation of the market; costs of production, including the costs of land, labour, and capital; transport costs; the level of the market (*e.g.* retail or wholesale); the date and time of transactions; and so forth. The facts and circumstances of the particular case will determine whether differences in economic circumstances have a material effect on price and whether reasonably accurate adjustments can be made to eliminate the effects of such differences, see paragraph 1.38.

1.56 The existence of a cycle (economic, business, or product cycle) is one of the economic circumstances that may affect comparability. See paragraph 3.77 in relation to the use of multiple year data where there are cycles.

1.57 The geographic market is another economic circumstance that can affect comparability. The identification of the relevant market is a factual question. For a number of industries, large regional markets encompassing more than one country may prove to be reasonably homogeneous, while for others, differences among domestic markets (or even within domestic markets) are very significant.

1.58 In cases where similar controlled transactions are carried out by an MNE group in several countries and where the economic circumstances in these countries are in effect reasonably homogeneous, it may be appropriate for this MNE group to rely on a multiple-country comparability analysis to support its transfer pricing policy towards this group of countries. But there are also numerous situations where an MNE group offers significantly different ranges of products or services in each country, and/or performs significantly different functions in each of these countries (using significantly different assets and assuming significantly different risks), and/or where its business strategies and/or economic circumstances are found to be significantly different. In these latter situations, the recourse to a multiple-country approach may reduce reliability.

#### D.1.2.5 Business strategies

1.59 Business strategies must also be examined in determining comparability for transfer pricing purposes. Business strategies would take into account many aspects of an enterprise, such as innovation and new product development, degree of diversification, risk aversion, assessment of political changes, input of existing and planned labour laws, duration of arrangements, and other factors bearing upon the

daily conduct of business. Such business strategies may need to be taken into account when determining the comparability of controlled and uncontrolled transactions and enterprises.

1.60 Business strategies also could include market penetration schemes. A taxpayer seeking to penetrate a market or to increase its market share might temporarily charge a price for its product that is lower than the price charged for otherwise comparable products in the same market. Furthermore, a taxpayer seeking to enter a new market or expand (or defend) its market share might temporarily incur higher costs (*e.g.* due to start-up costs or increased marketing efforts) and hence achieve lower profit levels than other taxpayers operating in the same market.

1.61 Timing issues can pose particular problems for tax administrations when evaluating whether a taxpayer is following a business strategy that distinguishes it from potential comparables. Some business strategies, such as those involving market penetration or expansion of market share, involve reductions in the taxpayer's current profits in anticipation of increased future profits. If in the future those increased profits fail to materialize because the purported business strategy was not actually followed by the taxpayer, legal constraints may prevent re-examination of earlier tax years by the tax administrations. At least in part for this reason, tax administrations may wish to subject the issue of business strategies to particular scrutiny.

1.62 When evaluating whether a taxpayer was following a business strategy that temporarily decreased profits in return for higher long-run profits, several factors should be considered. Tax administrations should examine the conduct of the parties to determine if it is consistent with the purported business strategy. For example, if a manufacturer charges its associated distributor a below-market price as part of a market penetration strategy, the cost savings to the distributor may be reflected in the price charged to the distributor's customers or in greater market penetration expenses incurred by the distributor. A market penetration strategy of an MNE group could be put in place by the manufacturer or by the distributor acting separately from the manufacturer (and the resulting cost borne by either of them). Furthermore, unusually intensive marketing and advertising efforts would often accompany a market penetration or market share expansion strategy. Another factor to consider is whether the nature of the relationship between the parties to the controlled transaction would be consistent with the taxpayer bearing the costs of the business strategy. For example, in arm's length transactions a company acting solely as a sales agent with little or no responsibility for long-term market development would generally not bear the costs of a market penetration strategy. Where a company has undertaken market development activities at its own risk and enhances the value of a product through a trademark or trade name or increases goodwill associated with the product, this situation should be reflected in the analysis of functions for the purposes of establishing comparability.

1.63 An additional consideration is whether there is a plausible expectation that following the business strategy will produce a return sufficient to justify its costs within a period of time that would be acceptable in an arm's length arrangement. It is recognised that a business strategy such as market penetration may fail, and the failure does not of itself allow the strategy to be ignored for transfer pricing purposes. However, if such an expected outcome was implausible at the time of the transaction, or if the business strategy is unsuccessful but nonetheless is continued beyond what an independent enterprise would accept, the arm's length nature of the business strategy may be doubtful. In determining what period of time an independent enterprise would accept, tax administrations may wish to consider evidence of the commercial strategies evident in the country in which the business strategy is being pursued. In the end, however, the most important consideration is whether the strategy in question could plausibly be expected to prove profitable within the foreseeable future (while recognising that the strategy might fail), and that a party operating at arm's length would have been prepared to sacrifice profitability for a similar period under such economic circumstances and competitive conditions.

## ***D.2 Recognition of the actual transactions undertaken***

1.64 A tax administration's examination of a controlled transaction ordinarily should be based on the transaction actually undertaken by the associated enterprises as it has been structured by them, using the methods applied by the taxpayer insofar as these are consistent with the methods described in Chapter II. In other than exceptional cases, the tax administration should not disregard the actual transactions or substitute other transactions for them. Restructuring of legitimate business transactions would be a wholly arbitrary exercise the inequity of which could be compounded by double taxation created where the other tax administration does not share the same views as to how the transaction should be structured.

1.65 However, there are two particular circumstances in which it may, exceptionally, be both appropriate and legitimate for a tax administration to consider disregarding the structure adopted by a taxpayer in entering into a controlled transaction. The first circumstance arises where the economic substance of a transaction differs from its form. In such a case the tax administration may disregard the parties' characterisation of the transaction and re-characterise it in accordance with its substance. An example of this circumstance would be an investment in an associated enterprise in the form of interest-bearing debt when, at arm's length, having regard to the economic circumstances of the borrowing company, the investment would not be expected to be structured in this way. In this case it might be appropriate for a tax administration to characterise the investment in accordance with its economic substance with the result that the loan may be treated as a subscription of capital. The second circumstance arises where, while the form and substance of the transaction are the same, the arrangements made in relation to the transaction, viewed in their totality, differ from those which would have been adopted by independent enterprises behaving in a commercially rational manner and the actual structure practically impedes the tax administration from determining an appropriate transfer price. An example of this circumstance would be a sale under a long-term contract, for a lump sum payment, of unlimited entitlement to the intellectual property rights arising as a result of future research for the term of the contract (as indicated in paragraph 1.11). While in this case it may be proper to respect the transaction as a transfer of commercial property, it would nevertheless be appropriate for a tax administration to conform the terms of that transfer in their entirety (and not simply by reference to pricing) to those that might reasonably have been expected had the transfer of property been the subject of a transaction involving independent enterprises. Thus, in the case described above it might be appropriate for the tax administration, for example, to adjust the conditions of the agreement in a commercially rational manner as a continuing research agreement.

1.66 In both sets of circumstances described above, the character of the transaction may derive from the relationship between the parties rather than be determined by normal commercial conditions and may have been structured by the taxpayer to avoid or minimise tax. In such cases, the totality of its terms would be the result of a condition that would not have been made if the parties had been engaged in arm's length transactions. Article 9 would thus allow an adjustment of conditions to reflect those which the parties would have attained had the transaction been structured in accordance with the economic and commercial reality of parties transacting at arm's length.

1.67 Associated enterprises are able to make a much greater variety of contracts and arrangements than can independent enterprises because the normal conflict of interest which would exist between independent parties is often absent. Associated enterprises may and frequently do conclude arrangements of a specific nature that are not or are very rarely encountered between independent parties. This may be done for various economic, legal, or fiscal reasons dependent on the circumstances in a particular case. Moreover, contracts within an MNE could be quite easily altered, suspended, extended, or terminated according to the overall strategies of the MNE as a whole, and such alterations may even be made retroactively. In such instances tax administrations would have to determine what the underlying reality is behind a contractual arrangement in applying the arm's length principle.

1.68 In addition, tax administrations may find it useful to refer to alternatively structured transactions between independent enterprises to determine whether the controlled transaction as structured satisfies the arm's length principle. Whether evidence from a particular alternative can be considered will depend on the facts and circumstances of the particular case, including the number and accuracy of the adjustments necessary to account for differences between the controlled transaction and the alternative and the quality of any other evidence that may be available.

1.69 The difference between restructuring the controlled transaction under review which, as stated above, generally is inappropriate, and using alternatively structured transactions as comparable uncontrolled transactions is demonstrated in the following example. Suppose a manufacturer sells goods to a controlled distributor located in another country and the distributor accepts all currency risk associated with these transactions. Suppose further that similar transactions between independent manufacturers and distributors are structured differently in that the manufacturer, and not the distributor, bears all currency risk. In such a case, the tax administration should not disregard the controlled taxpayer's purported assignment of risk unless there is good reason to doubt the economic substance of the controlled distributor's assumption of currency risk. The fact that independent enterprises do not structure their transactions in a particular fashion might be a reason to examine the economic logic of the structure more closely, but it would not be determinative. However, the uncontrolled transactions involving a differently structured allocation of currency risk could be useful in pricing the controlled transaction, perhaps employing the comparable uncontrolled price method if sufficiently accurate adjustments to their prices could be made to reflect the difference in the structure of the transactions.

### ***D.3 Losses***

1.70 When an associated enterprise consistently realizes losses while the MNE group as a whole is profitable, the facts could trigger some special scrutiny of transfer pricing issues. Of course, associated enterprises, like independent enterprises, can sustain genuine losses, whether due to heavy start-up costs, unfavourable economic conditions, inefficiencies, or other legitimate business reasons. However, an independent enterprise would not be prepared to tolerate losses that continue indefinitely. An independent enterprise that experiences recurring losses will eventually cease to undertake business on such terms. In contrast, an associated enterprise that realizes losses may remain in business if the business is beneficial to the MNE group as a whole.

1.71 The fact that there is an enterprise making losses that is doing business with profitable members of its MNE group may suggest to the taxpayers or tax administrations that the transfer pricing should be examined. The loss enterprise may not be receiving adequate compensation from the MNE group of which it is a part in relation to the benefits derived from its activities. For example, an MNE group may need to produce a full range of products and/or services in order to remain competitive and realize an overall profit, but some of the individual product lines may regularly lose revenue. One member of the MNE group might realize consistent losses because it produces all the loss-making products while other members produce the profit-making products. An independent enterprise would perform such a service only if it were compensated by an adequate service charge. Therefore, one way to approach this type of transfer pricing problem would be to deem the loss enterprise to receive the same type of service charge that an independent enterprise would receive under the arm's length principle.

1.72 A factor to consider in analysing losses is that business strategies may differ from MNE group to MNE group due to a variety of historic, economic, and cultural reasons. Recurring losses for a reasonable period may be justified in some cases by a business strategy to set especially low prices to achieve market penetration. For example, a producer may lower the prices of its goods, even to the extent of temporarily incurring losses, in order to enter new markets, to increase its share of an existing market, to introduce new products or services, or to discourage potential competitors. However, especially low prices should be

expected for a limited period only, with the specific object of improving profits in the longer term. If the pricing strategy continues beyond a reasonable period, a transfer pricing adjustment may be appropriate, particularly where comparable data over several years show that the losses have been incurred for a period longer than that affecting comparable independent enterprises. Further, tax administrations should not accept especially low prices (*e.g.* pricing at marginal cost in a situation of underemployed production capacities) as arm's length prices unless independent enterprises could be expected to have determined prices in a comparable manner.

#### ***D.4 The effect of government policies***

1.73 There are some circumstances in which a taxpayer will consider that an arm's length price must be adjusted to account for government interventions such as price controls (even price cuts), interest rate controls, controls over payments for services or management fees, controls over the payment of royalties, subsidies to particular sectors, exchange control, anti-dumping duties, or exchange rate policy. As a general rule, these government interventions should be treated as conditions of the market in the particular country, and in the ordinary course they should be taken into account in evaluating the taxpayer's transfer price in that market. The question then presented is whether in light of these conditions the transactions undertaken by the controlled parties are consistent with transactions between independent enterprises.

1.74 One issue that arises is determining the stage at which a price control affects the price of a product or service. Often the direct impact will be on the final price to the consumer, but there may nonetheless be an impact on prices paid at prior stages in the supply of goods to the market. MNEs in practice may make no adjustment in their transfer prices to take account of such controls, leaving the final seller to suffer any limitation on profit that may occur, or they may charge prices that share the burden in some way between the final seller and the intermediate supplier. It should be considered whether or not an independent supplier would share in the costs of the price controls and whether an independent enterprise would seek alternative product lines and business opportunities. In this regard, it is unlikely that an independent enterprise would be prepared to produce, distribute, or otherwise provide products or services on terms that allowed it no profit. Nevertheless, it is quite obvious that a country with price controls must take into account that those price controls will affect the profits that can be realised by enterprises selling goods subject to those controls.

1.75 A special problem arises when a country prevents or "blocks" the payment of an amount which is owed by one associated enterprise to another or which in an arm's length arrangement would be charged by one associated enterprise to another. For example, exchange controls may effectively prevent an associated enterprise from transferring interest payments abroad on a loan made by another associated enterprise located in a different country. This circumstance may be treated differently by the two countries involved: the country of the borrower may or may not regard the untransferred interest as having been paid, and the country of the lender may or may not treat the lender as having received the interest. As a general rule, where the government intervention applies equally to transactions between associated enterprises and transactions between independent enterprises (both in law and in fact), the approach to this problem where it occurs between associated enterprises should be the same for tax purposes as that adopted for transactions between independent enterprises. Where the government intervention applies only to transactions between associated enterprises, there is no simple solution to the problem. Perhaps one way to deal with the issue is to apply the arm's length principle viewing the intervention as a condition affecting the terms of the transaction. Treaties may specifically address the approaches available to the treaty partners where such circumstances exist.

1.76 A difficulty with this analysis is that often independent enterprises simply would not enter into a transaction in which payments were blocked. An independent enterprise might find itself in such an arrangement from time to time, most likely because the government interventions were imposed

subsequent to the time that the arrangement began. But it seems unlikely that an independent enterprise would willingly subject itself to a substantial risk of non-payment for products or services rendered by entering into an arrangement when severe government interventions already existed unless the profit projections or anticipated return from the independent enterprise's proposed business strategy are sufficient to yield it an acceptable rate of return notwithstanding the existence of the government intervention that may affect payment.

1.77 Because independent enterprises might not engage in a transaction subject to government interventions, it is unclear how the arm's length principle should apply. One possibility is to treat the payment as having been made between the associated enterprises, on the assumption that an independent enterprise in a similar circumstance would have insisted on payment by some other means. This approach would treat the party to whom the blocked payment is owed as performing a service for the MNE group. An alternative approach that may be available in some countries would be to defer both the income and the relevant expenses of the taxpayer. In other words, the party to whom this blocked payment was due would not be allowed to deduct expenses, such as additional financing costs, until the blocked payment was made. The concern of tax administrations in these situations is mainly their respective tax bases. If an associated enterprise claims a deduction in its tax computations for a blocked payment, then there should be corresponding income to the other party. In any case, a taxpayer should not be permitted to treat blocked payments due from an associated enterprise differently from blocked payments due from an independent enterprise.

#### ***D.5 Use of customs valuations***

1.78 The arm's length principle is applied, broadly speaking, by many customs administrations as a principle of comparison between the value attributable to goods imported by associated enterprises, which may be affected by the special relationship between them, and the value for similar goods imported by independent enterprises. Valuation methods for customs purposes however may not be aligned with the OECD's recognised transfer pricing methods. That being said, customs valuations may be useful to tax administrations in evaluating the arm's length character of a controlled transaction transfer price and vice versa. In particular, customs officials may have contemporaneous information regarding the transaction that could be relevant for transfer pricing purposes, especially if prepared by the taxpayer, while tax authorities may have transfer pricing documentation which provides detailed information on the circumstances of the transaction.

1.79 Taxpayers may have competing incentives in setting values for customs and tax purposes. In general, a taxpayer importing goods may be interested in setting a low price for the transaction for customs purposes so that the customs duty imposed will be low. (There could be similar considerations arising with respect to value added taxes, sales taxes, and excise taxes.) For tax purposes, however, a higher price paid for those same goods would increase the deductible costs in the importing country (although this would also increase the sales revenue of the seller in the country of export). Cooperation between income tax and customs administrations within a country in evaluating transfer prices is becoming more common and this should help to reduce the number of cases where customs valuations are found unacceptable for tax purposes or vice versa. Greater cooperation in the area of exchange of information would be particularly useful, and should not be difficult to achieve in countries that already have integrated administrations for income taxes and customs duties. Countries that have separate administrations may wish to consider modifying the exchange of information rules so that the information can flow more easily between the different administrations.

## Chapter II

### Transfer Pricing Methods

#### *Part I: Selection of the transfer pricing method*

##### **A. Selection of the most appropriate transfer pricing method to the circumstances of the case**

2.1 Parts II and III of this chapter respectively describe “traditional transaction methods” and “transactional profit methods” that can be used to establish whether the conditions imposed in the commercial or financial relations between associated enterprises are consistent with the arm's length principle. Traditional transaction methods are the comparable uncontrolled price method or CUP method, the resale price method, and the cost plus method. Transactional profit methods are the transactional net margin method and the transactional profit split method.

2.2 The selection of a transfer pricing method always aims at finding the most appropriate method for a particular case. For this purpose, the selection process should take account of the respective strengths and weaknesses of the OECD recognised methods; the appropriateness of the method considered in view of the nature of the controlled transaction, determined in particular through a functional analysis; the availability of reliable information (in particular on uncontrolled comparables) needed to apply the selected method and/or other methods; and the degree of comparability between controlled and uncontrolled transactions, including the reliability of comparability adjustments that may be needed to eliminate material differences between them. No one method is suitable in every possible situation, nor is it necessary to prove that a particular method is not suitable under the circumstances.

2.3 Traditional transaction methods are regarded as the most direct means of establishing whether conditions in the commercial and financial relations between associated enterprises are arm's length. This is because any difference in the price of a controlled transaction from the price in a comparable uncontrolled transaction can normally be traced directly to the commercial and financial relations made or imposed between the enterprises, and the arm's length conditions can be established by directly substituting the price in the comparable uncontrolled transaction for the price of the controlled transaction. As a result, where, taking account of the criteria described at paragraph 2.2, a traditional transaction method and a transactional profit method can be applied in an equally reliable manner, the traditional transaction method is preferable to the transactional profit method. Moreover, where, taking account of the criteria described at paragraph 2.2, the comparable uncontrolled price method (CUP) and another transfer pricing method can be applied in an equally reliable manner, the CUP method is to be preferred. See paragraphs 2.13-2.20 for a discussion of the CUP method.

2.4 There are situations where transactional profit methods are found to be more appropriate than traditional transaction methods. For example, cases where each of the parties makes valuable and unique contributions in relation to the controlled transaction, or where the parties engage in highly integrated activities, may make a transactional profit split more appropriate than a one-sided method. As another example, where there is no or limited publicly available reliable gross margin information on third parties, traditional transaction methods might be difficult to apply in cases other than those where there are internal comparables, and a transactional profit method might be the most appropriate method in view of the availability of information.

2.5 However, it is not appropriate to apply a transactional profit method merely because data concerning uncontrolled transactions are difficult to obtain or incomplete in one or more respects. The same criteria listed in paragraph 2.2 that were used to reach the initial conclusion that none of the

traditional transactional methods could be reliably applied under the circumstances must be considered again in evaluating the reliability of the transactional profit method.

2.6 Methods that are based on profits can be accepted only insofar as they are compatible with Article 9 of the OECD Model Tax Convention, especially with regard to comparability. This is achieved by applying the methods in a manner that approximates arm's length pricing. The application of the arm's length principle is generally based on a comparison of the price, margin or profits from particular controlled transactions with the price, margin or profits from comparable transactions between independent enterprises. In the case of a transactional profit split method, it is based on an approximation of the division of profits that independent enterprises would have expected to realise from engaging in the transaction(s) (see paragraph 2.108).

2.7 In no case should transactional profit methods be used so as to result in over-taxing enterprises mainly because they make profits lower than the average, or in under-taxing enterprises that make higher than average profits. There is no justification under the arm's length principle for imposing additional tax on enterprises that are less successful than average or, conversely, for under-taxing enterprises that are more successful than average, when the reason for their success or lack thereof is attributable to commercial factors.

2.8 The guidance at paragraph 2.2 that the selection of a transfer pricing method always aims at finding the most appropriate method for each particular case does not mean that all the transfer pricing methods should be analysed in depth or tested in each case in arriving at the selection of the most appropriate method. As a matter of good practice, the selection of the most appropriate method and comparables should be evidenced and can be part of a typical search process as proposed at paragraph 3.4.

2.9 Moreover, MNE groups retain the freedom to apply methods not described in these Guidelines (hereafter "other methods") to establish prices provided those prices satisfy the arm's length principle in accordance with these Guidelines. Such other methods should however not be used in substitution for OECD-recognised methods where the latter are more appropriate to the facts and circumstances of the case. In cases where other methods are used, their selection should be supported by an explanation of why OECD-recognised methods were regarded as less appropriate or non-workable in the circumstances of the case and of the reason why the selected other method was regarded as providing a better solution. A taxpayer should maintain and be prepared to provide documentation regarding how its transfer prices were established. For a discussion of documentation, see Chapter V.

2.10 It is not possible to provide specific rules that will cover every case. Tax administrators should hesitate from making minor or marginal adjustments. In general, the parties should attempt to reach a reasonable accommodation keeping in mind the imprecision of the various methods and the preference for higher degrees of comparability and a more direct and closer relationship to the transaction. It should not be the case that useful information, such as might be drawn from uncontrolled transactions that are not identical to the controlled transactions, should be dismissed simply because some rigid standard of comparability is not fully met. Similarly, evidence from enterprises engaged in controlled transactions with associated enterprises may be useful in understanding the transaction under review or as a pointer to further investigation. Further, any method should be permitted where its application is agreeable to the members of the MNE group involved with the transaction or transactions to which the methodology applies and also to the tax administrations in the jurisdictions of all those members.

## **B. Use of more than one method**

2.11 The arm's length principle does not require the application of more than one method for a given transaction (or set of transactions that are appropriately aggregated following the standard described at

paragraph 3.9), and in fact undue reliance on such an approach could create a significant burden for taxpayers. Thus, these Guidelines do not require either the tax examiner or taxpayer to perform analyses under more than one method. While in some cases the selection of a method may not be straightforward and more than one method may be initially considered, generally it will be possible to select one method that is apt to provide the best estimation of an arm's length price. However, for difficult cases, where no one approach is conclusive, a flexible approach would allow the evidence of various methods to be used in conjunction. In such cases, an attempt should be made to reach a conclusion consistent with the arm's length principle that is satisfactory from a practical viewpoint to all the parties involved, taking into account the facts and circumstances of the case, the mix of evidence available, and the relative reliability of the various methods under consideration. See paragraphs 3.58-3.59 for a discussion of cases where a range of figures results from the use of more than one method.

## *Part II: Traditional transaction methods*

### **A. Introduction**

2.12 This part provides a detailed description of traditional transaction methods that are used to apply the arm's length principle. These methods are the comparable uncontrolled price method or CUP method, the resale price method, and the cost plus method.

### **B. Comparable uncontrolled price method**

#### ***B.1 In general***

2.13 The CUP method compares the price charged for property or services transferred in a controlled transaction to the price charged for property or services transferred in a comparable uncontrolled transaction in comparable circumstances. If there is any difference between the two prices, this may indicate that the conditions of the commercial and financial relations of the associated enterprises are not arm's length, and that the price in the uncontrolled transaction may need to be substituted for the price in the controlled transaction.

2.14 Following the principles in Chapter I, an uncontrolled transaction is comparable to a controlled transaction (*i.e.* it is a comparable uncontrolled transaction) for purposes of the CUP method if one of two conditions is met: a) none of the differences (if any) between the transactions being compared or between the enterprises undertaking those transactions could materially affect the price in the open market; or, b) reasonably accurate adjustments can be made to eliminate the material effects of such differences. Where it is possible to locate comparable uncontrolled transactions, the CUP method is the most direct and reliable way to apply the arm's length principle. Consequently, in such cases the CUP method is preferable over all other methods.

2.15 It may be difficult to find a transaction between independent enterprises that is similar enough to a controlled transaction such that no differences have a material effect on price. For example, a minor difference in the property transferred in the controlled and uncontrolled transactions could materially affect the price even though the nature of the business activities undertaken may be sufficiently similar to generate the same overall profit margin. When this is the case, some adjustments will be appropriate. As discussed below in paragraph 2.16, the extent and reliability of such adjustments will affect the relative reliability of the analysis under the CUP method.

2.16 In considering whether controlled and uncontrolled transactions are comparable, regard should be had to the effect on price of broader business functions other than just product comparability (*i.e.* factors relevant to determining comparability under Chapter I). Where differences exist between the controlled and uncontrolled transactions or between the enterprises undertaking those transactions, it may be difficult to determine reasonably accurate adjustments to eliminate the effect on price. The difficulties that arise in attempting to make reasonably accurate adjustments should not routinely preclude the possible application of the CUP method. Practical considerations dictate a more flexible approach to enable the CUP method to be used and to be supplemented as necessary by other appropriate methods, all of which should be evaluated according to their relative accuracy. Every effort should be made to adjust the data so that it may be used appropriately in a CUP method. As for any method, the relative reliability of the CUP method is affected by the degree of accuracy with which adjustments can be made to achieve comparability.

## **B.2 Examples of the application of the CUP method**

2.17 The following examples illustrate the application of the CUP method, including situations where adjustments may need to be made to uncontrolled transactions to make them comparable uncontrolled transactions.

2.18 The CUP method is a particularly reliable method where an independent enterprise sells the same product as is sold between two associated enterprises. For example, an independent enterprise sells unbranded Colombian coffee beans of a similar type, quality, and quantity as those sold between two associated enterprises, assuming that the controlled and uncontrolled transactions occur at about the same time, at the same stage in the production/distribution chain, and under similar conditions. If the only available uncontrolled transaction involved unbranded Brazilian coffee beans, it would be appropriate to inquire whether the difference in the coffee beans has a material effect on the price. For example, it could be asked whether the source of coffee beans commands a premium or requires a discount generally in the open market. Such information may be obtainable from commodity markets or may be deduced from dealer prices. If this difference does have a material effect on price, some adjustments would be appropriate. If a reasonably accurate adjustment cannot be made, the reliability of the CUP method would be reduced, and it might be necessary to select another less direct method instead.

2.19 One illustrative case where adjustments may be required is where the circumstances surrounding controlled and uncontrolled sales are identical, except for the fact that the controlled sales price is a delivered price and the uncontrolled sales are made f.o.b. factory. The differences in terms of transportation and insurance generally have a definite and reasonably ascertainable effect on price. Therefore, to determine the uncontrolled sales price, adjustment should be made to the price for the difference in delivery terms.

2.20 As another example, assume a taxpayer sells 1,000 tons of a product for \$80 per ton to an associated enterprise in its MNE group, and at the same time sells 500 tons of the same product for \$100 per ton to an independent enterprise. This case requires an evaluation of whether the different volumes should result in an adjustment of the transfer price. The relevant market should be researched by analysing transactions in similar products to determine typical volume discounts.

## **C. Resale price method**

### **C.1 In general**

2.21 The resale price method begins with the price at which a product that has been purchased from an associated enterprise is resold to an independent enterprise. This price (the resale price) is then reduced by an appropriate gross margin on this price (the “resale price margin”) representing the amount out of which the reseller would seek to cover its selling and other operating expenses and, in the light of the functions performed (taking into account assets used and risks assumed), make an appropriate profit. What is left after subtracting the gross margin can be regarded, after adjustment for other costs associated with the purchase of the product (*e.g.* customs duties), as an arm’s length price for the original transfer of property between the associated enterprises. This method is probably most useful where it is applied to marketing operations.

2.22 The resale price margin of the reseller in the controlled transaction may be determined by reference to the resale price margin that the same reseller earns on items purchased and sold in comparable uncontrolled transactions (“internal comparable”). Also, the resale price margin earned by an independent enterprise in comparable uncontrolled transactions may serve as a guide (“external comparable”). Where the reseller is carrying on a general brokerage business, the resale price margin may be related to a

brokerage fee, which is usually calculated as a percentage of the sales price of the product sold. The determination of the resale price margin in such a case should take into account whether the broker is acting as an agent or a principal.

2.23 Following the principles in Chapter I, an uncontrolled transaction is comparable to a controlled transaction (*i.e.* it is a comparable uncontrolled transaction) for purposes of the resale price method if one of two conditions is met: a) none of the differences (if any) between the transactions being compared or between the enterprises undertaking those transactions could materially affect the resale price margin in the open market; or, b) reasonably accurate adjustments can be made to eliminate the material effects of such differences. In making comparisons for purposes of the resale price method, fewer adjustments are normally needed to account for product differences than under the CUP method, because minor product differences are less likely to have as material an effect on profit margins as they do on price.

2.24 In a market economy, the compensation for performing similar functions would tend to be equalized across different activities. In contrast, prices for different products would tend to equalize only to the extent that those products were substitutes for one another. Because gross profit margins represent gross compensation, after the cost of sales for specific functions performed (taking into account assets used and risks assumed), product differences are less significant. For example, the facts may indicate that a distribution company performs the same functions (taking into account assets used and risks assumed) selling toasters as it would selling blenders, and hence in a market economy there should be a similar level of compensation for the two activities. However, consumers would not consider toasters and blenders to be particularly close substitutes, and hence there would be no reason to expect their prices to be the same.

2.25 Although broader product differences can be allowed in the resale price method, the property transferred in the controlled transaction must still be compared to that being transferred in the uncontrolled transaction. Broader differences are more likely to be reflected in differences in functions performed between the parties to the controlled and uncontrolled transactions. While less product comparability may be required in using the resale price method, it remains the case that closer comparability of products will produce a better result. For example, where there is a valuable or unique intangible involved in the transaction, product similarity may assume greater importance and particular attention should be paid to it to ensure that the comparison is valid.

2.26 It may be appropriate to give more weight to other attributes of comparability discussed in Chapter I (*i.e.* functions performed, economic circumstances, etc.) when the profit margin relates primarily to those other attributes and only secondarily to the particular product being transferred. This circumstance will usually exist where the profit margin is determined for an associated enterprise that has not used unique assets (such as valuable, unique intangibles) to add significant value to the product being transferred. Thus, where uncontrolled and controlled transactions are comparable in all characteristics other than the product itself, the resale price method might produce a more reliable measure of arm's length conditions than the CUP method, unless reasonably accurate adjustments could be made to account for differences in the products transferred. The same point is true for the cost plus method, discussed below.

2.27 When the resale price margin used is that of an independent enterprise in a comparable transaction, the reliability of the resale price method may be affected if there are material differences in the ways the associated enterprises and independent enterprises carry out their businesses. Such differences could include those that affect the level of costs taken into account (*e.g.* the differences could include the effect of management efficiency on levels and ranges of inventory maintenance), which may well have an impact on the profitability of an enterprise but which may not necessarily affect the price at which it buys or sells its goods or services in the open market. These types of characteristics should be analyzed in

determining whether an uncontrolled transaction is comparable for purposes of applying the resale price method.

2.28 The resale price method also depends on comparability of functions performed (taking into account assets used and risks assumed). It may become less reliable when there are differences between the controlled and uncontrolled transactions and the parties to the transactions, and those differences have a material effect on the attribute being used to measure arm's length conditions, in this case the resale price margin realised. Where there are material differences that affect the gross margins earned in the controlled and uncontrolled transactions (*e.g.* in the nature of the functions performed by the parties to the transactions), adjustments should be made to account for such differences. The extent and reliability of those adjustments will affect the relative reliability of the analysis under the resale price method in any particular case.

2.29 An appropriate resale price margin is easiest to determine where the reseller does not add substantially to the value of the product. In contrast, it may be more difficult to use the resale price method to arrive at an arm's length price where, before resale, the goods are further processed or incorporated into a more complicated product so that their identity is lost or transformed (*e.g.* where components are joined together in finished or semi-finished goods). Another example where the resale price margin requires particular care is where the reseller contributes substantially to the creation or maintenance of intangible property associated with the product (*e.g.* trademarks or trade names) which are owned by an associated enterprise. In such cases, the contribution of the goods originally transferred to the value of the final product cannot be easily evaluated.

2.30 A resale price margin is more accurate where it is realised within a short time of the reseller's purchase of the goods. The more time that elapses between the original purchase and resale the more likely it is that other factors – changes in the market, in rates of exchange, in costs, etc. – will need to be taken into account in any comparison.

2.31 It should be expected that the amount of the resale price margin will be influenced by the level of activities performed by the reseller. This level of activities can range widely from the case where the reseller performs only minimal services as a forwarding agent to the case where the reseller takes on the full risk of ownership together with the full responsibility for and the risks involved in advertising, marketing, distributing and guaranteeing the goods, financing stocks, and other connected services. If the reseller in the controlled transaction does not carry on a substantial commercial activity but only transfers the goods to a third party, the resale price margin could, in light of the functions performed, be a small one. The resale price margin could be higher where it can be demonstrated that the reseller has some special expertise in the marketing of such goods, in effect bears special risks, or contributes substantially to the creation or maintenance of intangible property associated with the product. However, the level of activity performed by the reseller, whether minimal or substantial, would need to be well supported by relevant evidence. This would include justification for marketing expenditures that might be considered unreasonably high; for example, when part or most of the promotional expenditure was clearly incurred as a service performed in favour of the legal owner of the trademark. In such a case the cost plus method may well supplement the resale price method.

2.32 Where the reseller is clearly carrying on a substantial commercial activity in addition to the resale activity itself, then a reasonably substantial resale price margin might be expected. If the reseller in its activities employs valuable and possibly unique assets (*e.g.* intangible property of the reseller, such as its marketing organisation), it may be inappropriate to evaluate the arm's length conditions in the controlled transaction using an unadjusted resale price margin derived from uncontrolled transactions in which the uncontrolled reseller does not employ similar assets. If the reseller possesses valuable marketing intangibles, the resale price margin in the uncontrolled transaction may underestimate the profit to which

the reseller in the controlled transaction is entitled, unless the comparable uncontrolled transaction involves the same reseller or a reseller with similarly valuable marketing intangibles.

2.33 In a case where there is a chain of distribution of goods through an intermediate company, it may be relevant for tax administrations to look not only at the resale price of goods that have been purchased from the intermediate company but also at the price that such company pays to its own supplier and the functions that the intermediate company undertakes. There could well be practical difficulties in obtaining this information and the true function of the intermediate company may be difficult to determine. If it cannot be demonstrated that the intermediate company either bears a real risk or performs an economic function in the chain that has increased the value of the goods, then any element in the price that is claimed to be attributable to the activities of the intermediate company would reasonably be attributed elsewhere in the MNE group, because independent enterprises would not normally have allowed such a company to share in the profits of the transaction.

2.34 The resale price margin should also be expected to vary according to whether the reseller has the exclusive right to resell the goods. Arrangements of this kind are found in transactions between independent enterprises and may influence the margin. Thus, this type of exclusive right should be taken into account in any comparison. The value to be attributed to such an exclusive right will depend to some extent upon its geographical scope and the existence and relative competitiveness of possible substitute goods. The arrangement may be valuable to both the supplier and the reseller in an arm's length transaction. For instance, it may stimulate the reseller to greater efforts to sell the supplier's particular line of goods. On the other hand, such an arrangement may provide the reseller with a kind of monopoly with the result that the reseller possibly can realize a substantial turn over without great effort. Accordingly, the effect of this factor upon the appropriate resale price margin must be examined with care in each case.

2.35 Where the accounting practices differ from the controlled transaction to the uncontrolled transaction, appropriate adjustments should be made to the data used in calculating the resale price margin in order to ensure that the same types of costs are used in each case to arrive at the gross margin. For example, costs of R&D may be reflected in operating expenses or in costs of sales. The respective gross margins would not be comparable without appropriate adjustments.

## ***C.2 Examples of the application of the resale price method***

2.36 Assume that there are two distributors selling the same product in the same market under the same brand name. Distributor A offers a warranty; Distributor B offers none. Distributor A is not including the warranty as part of a pricing strategy and so sells its product at a higher price resulting in a higher gross profit margin (if the costs of servicing the warranty are not taken into account) than that of Distributor B, which sells at a lower price. The two margins are not comparable until a reasonably accurate adjustment is made to account for that difference.

2.37 Assume that a warranty is offered with respect to all products so that the downstream price is uniform. Distributor C performs the warranty function but is, in fact, compensated by the supplier through a lower price. Distributor D does not perform the warranty function which is performed by the supplier (products are sent back to the factory). However, Distributor D's supplier charges D a higher price than is charged to Distributor C. If Distributor C accounts for the cost of performing the warranty function as a cost of goods sold, then the adjustment in the gross profit margins for the differences is automatic. However, if the warranty expenses are accounted for as operating expenses, there is a distortion in the margins which must be corrected. The reasoning in this case would be that, if D performed the warranty itself, its supplier would reduce the transfer price, and therefore, D's gross profit margin would be greater.

2.38 A company sells a product through independent distributors in five countries in which it has no subsidiaries. The distributors simply market the product and do not perform any additional work. In one country, the company has set up a subsidiary. Because this particular market is of strategic importance, the company requires its subsidiary to sell only its product and to perform technical applications for the customers. Even if all other facts and circumstances are similar, if the margins are derived from independent enterprises that do not have exclusive sales arrangements or perform technical applications like those undertaken by the subsidiary, it is necessary to consider whether any adjustments must be made to achieve comparability.

## **D. Cost plus method**

### ***D.1 In general***

2.39 The cost plus method begins with the costs incurred by the supplier of property (or services) in a controlled transaction for property transferred or services provided to an associated purchaser. An appropriate cost plus mark up is then added to this cost, to make an appropriate profit in light of the functions performed and the market conditions. What is arrived at after adding the cost plus mark up to the above costs may be regarded as an arm's length price of the original controlled transaction. This method probably is most useful where semi finished goods are sold between associated parties, where associated parties have concluded joint facility agreements or long-term buy-and-supply arrangements, or where the controlled transaction is the provision of services.

2.40 The cost plus mark up of the supplier in the controlled transaction should ideally be established by reference to the cost plus mark up that the same supplier earns in comparable uncontrolled transactions ("internal comparable"). In addition, the cost plus mark up that would have been earned in comparable transactions by an independent enterprise may serve as a guide ("external comparable").

2.41 Following the principles in Chapter I, an uncontrolled transaction is comparable to a controlled transaction (*i.e.* it is a comparable uncontrolled transaction) for purposes of the cost plus method if one of two conditions is met: a) none of the differences (if any) between the transactions being compared or between the enterprises undertaking those transactions materially affect the cost plus mark up in the open market; or, b) reasonably accurate adjustments can be made to eliminate the material effects of such differences. In determining whether a transaction is a comparable uncontrolled transaction for the purposes of the cost plus method, the same principles apply as described in paragraphs 2.23-2.28 for the resale price method. Thus, fewer adjustments may be necessary to account for product differences under the cost plus method than the CUP method, and it may be appropriate to give more weight to other factors of comparability described in Chapter I, some of which may have a more significant effect on the cost plus mark up than they do on price. As under the resale price method (see paragraph 2.28), where there are differences that materially affect the cost plus mark ups earned in the controlled and uncontrolled transactions (for example in the nature of the functions performed by the parties to the transactions), reasonably accurate adjustments should be made to account for such differences. The extent and reliability of those adjustments will affect the relative reliability of the analysis under the cost plus method in particular cases.

2.42 For example, assume that Company A manufactures and sells toasters to a distributor that is an associated enterprise, that Company B manufactures and sells irons to a distributor that is an independent enterprise, and that the profit margins on the manufacture of basic toasters and irons are generally the same in the small household appliance industry. (The use of the cost plus method here presumes that there are no highly similar independent toaster manufacturers). If the cost plus method were being applied, the mark ups being compared in the controlled and uncontrolled transactions would be the difference between the selling price by the manufacturer to the distributor and the costs of manufacturing the product, divided by

the costs of manufacturing the product. However, Company A may be much more efficient in its manufacturing processes than Company B thereby enabling it to have lower costs. As a result, even if Company A were making irons instead of toasters and charging the same price as Company B is charging for irons (*i.e.* no special condition were to exist), it would be appropriate for Company A's profit level to be higher than that of Company B. Thus, unless it is possible to adjust for the effect of this difference on the profit, the application of the cost plus method would not be wholly reliable in this context.

2.43 The cost plus method presents some difficulties in proper application, particularly in the determination of costs. Although it is true that an enterprise must cover its costs over a period of time to remain in business, those costs may not be the determinant of the appropriate profit in a specific case for any one year. While in many cases companies are driven by competition to scale down prices by reference to the cost of creating the relevant goods or providing the relevant service, there are other circumstances where there is no discernible link between the level of costs incurred and a market price (*e.g.* where a valuable discovery has been made and the owner has incurred only small research costs in making it).

2.44 In addition, when applying the cost plus method one should pay attention to apply a comparable mark up to a comparable cost basis. For instance, if the supplier to which reference is made in applying the cost plus method in carrying out its activities employs leased business assets, the cost basis might not be comparable without adjustment if the supplier in the controlled transaction owns its business assets. The cost plus method relies upon a comparison of the mark up on costs achieved in a controlled transaction and the mark up on costs achieved in one or more comparable uncontrolled transactions. Therefore, differences between the controlled and uncontrolled transactions that have an effect on the size of the mark up must be analyzed to determine what adjustments should be made to the uncontrolled transactions' respective mark up.

2.45 For this purpose, it is particularly important to consider differences in the level and types of expenses – operating expenses and non-operating expenses including financing expenditures – associated with functions performed and risks assumed by the parties or transactions being compared. Consideration of these differences may indicate the following:

- a) If expenses reflect a functional difference (taking into account assets used and risks assumed) which has not been taken into account in applying the method, an adjustment to the cost plus mark up may be required.
- b) If the expenses reflect additional functions that are distinct from the activities tested by the method, separate compensation for those functions may need to be determined. Such functions may for example amount to the provision of services for which an appropriate reward may be determined. Similarly, expenses that are the result of capital structures reflecting non-arm's length arrangements may require separate adjustment.
- c) If differences in the expenses of the parties being compared merely reflect efficiencies or inefficiencies of the enterprises, as would normally be the case for supervisory, general, and administrative expenses, then no adjustment to the gross margin may be appropriate.

In any of the above circumstances it may be appropriate to supplement the cost plus and resale price methods by considering the results obtained from applying other methods (see paragraph 2.11).

2.46 Another important aspect of comparability is accounting consistency. Where the accounting practices differ in the controlled transaction and the uncontrolled transaction, appropriate adjustments should be made to the data used to ensure that the same type of costs are used in each case to ensure consistency. The gross profit mark ups must be measured consistently between the associated enterprise

and the independent enterprise. In addition, there may be differences across enterprises in the treatment of costs that affect gross profit mark ups that would need to be accounted for in order to achieve reliable comparability. In some cases it may be necessary to take into account certain operating expenses in order to achieve consistency and comparability; in these circumstances the cost plus method starts to approach a net rather than gross profit analysis. To the extent that the analysis takes into account operating expenses, its reliability may be adversely affected for the reasons set forth in paragraphs 2.64-2.67. Thus, the safeguards described in paragraphs 2.68-2.75 may be relevant in assessing the reliability of such analyses.

2.47 While precise accounting standards and terms may vary, in general the costs and expenses of an enterprise are understood to be divisible into three broad categories. First, there are the direct costs of producing a product or service, such as the cost of raw materials. Second, there are indirect costs of production, which although closely related to the production process may be common to several products or services (*e.g.* the costs of a repair department that services equipment used to produce different products). Finally, there are the operating expenses of the enterprise as a whole, such as supervisory, general, and administrative expenses.

2.48 The distinction between gross and net profit analyses may be understood in the following terms. In general, the cost plus method will use mark ups computed after direct and indirect costs of production, while a net profit method will use profits computed after operating expenses of the enterprise as well. It must be recognised that because of the variations in practice among countries, it is difficult to draw any precise lines between the three categories described above. Thus, for example, an application of the cost plus method may in a particular case include the consideration of some expenses that might be considered operating expenses, as discussed in paragraph 2.46. Nevertheless, the problems in delineating with mathematical precision the boundaries of the three categories described above do not alter the basic practical distinction between the gross and net profit approaches.

2.49 In principle historical costs should be attributed to individual units of production, although admittedly the cost plus method may over-emphasize historical costs. Some costs, for example costs of materials, labour, and transport will vary over a period and in such a case it may be appropriate to average the costs over the period. Averaging also may be appropriate across product groups or over a particular line of production. Further, averaging may be appropriate with respect to the costs of fixed assets where the production or processing of different products is carried on simultaneously and the volume of activity fluctuates. Costs such as replacement costs and marginal costs also may need to be considered where these can be measured and they result in a more accurate estimate of the appropriate profit.

2.50 The costs that may be considered in applying the cost plus method are limited to those of the supplier of goods or services. This limitation may raise a problem of how to allocate some costs between suppliers and purchasers. There is a possibility that some costs will be borne by the purchaser in order to diminish the supplier's cost base on which the mark up will be calculated. In practice, this may be achieved by not allocating to the supplier an appropriate share of overheads and other costs borne by the purchaser (often the parent company) for the benefit of the supplier (often a subsidiary). The allocation should be undertaken based on an analysis of functions performed (taking into account assets used and risks assumed) by the respective parties as provided in Chapter I. A related problem is how overhead costs should be apportioned, whether by reference to turnover, number or cost of employees, or some other criterion. The issue of cost allocation is also discussed in Chapter VIII on cost contribution arrangements.

2.51 In some cases, there may be a basis for using only variable or incremental (*e.g.* marginal) costs, because the transactions represent a disposal of marginal production. Such a claim could be justified if the goods could not be sold at a higher price in the relevant foreign market (see also the discussion of market penetration in Chapter I). Factors that could be taken into account in evaluating such a claim include information on whether the taxpayer has any other sales of the same or similar products in that particular

foreign market, the percentage of the taxpayers' production (in both volume and value terms) that the claimed "marginal production" represents, the term of the arrangement, and details of the marketing analysis that was undertaken by the taxpayer or MNE group which led to the conclusion that the goods could not be sold at a higher price in that foreign market.

2.52 No general rule can be set out that deals with all cases. The various methods for determining costs should be consistent as between the controlled and uncontrolled transactions and consistent over time in relation to particular enterprises. For example, in determining the appropriate cost plus mark up, it may be necessary to take into account whether products can be supplied by various sources at widely differing costs. Associated enterprises may choose to calculate their cost plus basis on a standardised basis. An independent party probably would not accept to pay a higher price resulting from the inefficiency of the other party. On the other hand, if the other party is more efficient than can be expected under normal circumstances, this other party should benefit from that advantage. The associated enterprise may agree in advance which costs would be acceptable as a basis for the cost plus method.

#### ***D.2 Examples of the application of the cost plus method***

2.53 A is a domestic manufacturer of timing mechanisms for mass-market clocks. A sells this product to its foreign subsidiary B. A earns a 5 percent gross profit mark up with respect to its manufacturing operation. X, Y, and Z are independent domestic manufacturers of timing mechanisms for mass-market watches. X, Y, and Z sell to independent foreign purchasers. X, Y, and Z earn gross profit mark ups with respect to their manufacturing operations that range from 3 to 5 percent. A accounts for supervisory, general, and administrative costs as operating expenses, and thus these costs are not reflected in cost of goods sold. The gross profit mark ups of X, Y, and Z, however, reflect supervisory, general, and administrative costs as part of costs of goods sold. Therefore, the gross profit mark ups of X, Y, and Z must be adjusted to provide accounting consistency.

2.54 Company C in country D is a 100% subsidiary of company E, located in country F. In comparison with country F, wages are very low in country D. At the expense and risk of company E, television sets are assembled by company C. All the necessary components, know-how, etc. are provided by company E. The purchase of the assembled product is guaranteed by company E in case the television sets fail to meet a certain quality standard. After the quality check the television sets are brought – at the expense and risk of company E – to distribution centres company E has in several countries. The function of company C can be described as a purely contract manufacturing function. The risks company C could bear are eventual differences in the agreed quality and quantity. The basis for applying the cost plus method will be formed by all the costs connected to the assembling activities.

2.55 Company A of an MNE group agrees with company B of the same MNE group to carry out contract research for company B. All risks of a failure of the research are born by company B. This company also owns all the intangibles developed through the research and therefore has also the profit chances resulting from the research. This is a typical setup for applying a cost plus method. All costs for the research, which the associated parties have agreed upon, have to be compensated. The additional cost plus may reflect how innovative and complex the research carried out is.

### ***Part III: Transactional profit methods***

#### **A. Introduction**

2.56 This Part provides a discussion of transactional profit methods that may be used to approximate arm's length conditions where such methods are the most appropriate to the circumstances of the case, see paragraphs 2.1-2.11. Transactional profit methods examine the profits that arise from particular transactions among associated enterprises. The only profit methods that satisfy the arm's length principle are those that are consistent with Article 9 of the OECD Model Tax Convention and follow the requirement for a comparability analysis as described in these Guidelines. In particular, so-called "comparable profits methods" or "modified cost plus/resale price methods" are acceptable only to the extent that they are consistent with these Guidelines.

2.57 A transactional profit method examines the profits that arise from particular controlled transactions. The transactional profit methods for purposes of these Guidelines are the transactional profit split method and the transactional net margin method. Profit arising from a controlled transaction can be a relevant indicator of whether the transaction was affected by conditions that differ from those that would have been made by independent enterprises in otherwise comparable circumstances.

#### **B. Transactional net margin method**

##### ***B.1 In general***

2.58 The transactional net margin method examines the net profit relative to an appropriate base (*e.g.* costs, sales, assets) that a taxpayer realises from a controlled transaction (or transactions that are appropriate to aggregate under the principles of paragraphs 3.9-3.12). Thus, a transactional net margin method operates in a manner similar to the cost plus and resale price methods. This similarity means that in order to be applied reliably, the transactional net margin method must be applied in a manner consistent with the manner in which the resale price or cost plus method is applied. This means in particular that the net profit indicator of the taxpayer from the controlled transaction (or transactions that are appropriate to aggregate under the principles of paragraphs 3.9-3.12) should ideally be established by reference to the net profit indicator that the same taxpayer earns in comparable uncontrolled transactions, *i.e.* by reference to "internal comparables" (see paragraphs 3.27-3.28). Where this is not possible, the net margin that would have been earned in comparable transactions by an independent enterprise ("external comparables") may serve as a guide (see paragraphs 3.29-3.35). A functional analysis of the controlled and uncontrolled transactions is required to determine whether the transactions are comparable and what adjustments may be necessary to obtain reliable results. Further, the other requirements for comparability, and in particular those of paragraphs 2.68 -2.75, must be applied.

2.59 A transactional net margin method is unlikely to be reliable if each party to a transaction makes valuable, unique contributions, see paragraph 2.4. In such a case, a transactional profit split method will generally be the most appropriate method, see paragraph 2.109. However, a one-sided method (traditional transaction method or transactional net margin method) may be applicable in cases where one of the parties makes all the unique contributions involved in the controlled transaction, while the other party does not make any unique contribution. In such a case, the tested party should be the less complex one. See paragraphs 3.18-3.19 for a discussion of the notion of tested party.

2.60 There are also many cases where a party to a transaction makes contributions that are not unique – *e.g.* uses non-unique intangibles such as non-unique business processes or non-unique market knowledge. In such cases, it may be possible to meet the comparability requirements to apply a traditional

transaction method or a transactional net margin method because the comparables would also be expected to use a comparable mix of non-unique contributions.

2.61 Finally, the lack of valuable and unique contributions involved in a particular transaction does not automatically imply that the transactional net margin method is the most appropriate method.

## **B.2 Strengths and weaknesses<sup>1</sup>**

2.62 One strength of the transactional net margin method is that net profit indicators (*e.g.* return on assets, operating income to sales, and possibly other measures of net profit) are less affected by transactional differences than is the case with price, as used in the CUP method. Net profit indicators also may be more tolerant to some functional differences between the controlled and uncontrolled transactions than gross profit margins. Differences in the functions performed between enterprises are often reflected in variations in operating expenses. Consequently, this may lead to a wide range of gross profit margins but still broadly similar levels of net operating profit indicators. In addition, in some countries the lack of clarity in the public data with respect to the classification of expenses in the gross or operating profits may make it difficult to evaluate the comparability of gross margins, while the use of net profit indicators may avoid the problem.

2.63 Another practical strength of the transactional net margin method is that, as with any one-sided method, it is necessary to examine a financial indicator for only one of the associated enterprises (the “tested” party). Similarly, it is often not necessary to state the books and records of all participants in the business activity on a common basis or to allocate costs for all participants as is the case with the transactional profit split method. This can be practically advantageous when one of the parties to the transaction is complex and has many interrelated activities or when it is difficult to obtain reliable information about one of the parties. However, a comparability (including functional) analysis must always be performed in order to appropriately characterise the transaction between the parties and choose the most appropriate transfer pricing method, and this analysis generally necessitates that some information on the five comparability factors in relation to the controlled transaction be collected on both the tested and the non-tested parties. See paragraphs 3.20-3.23.

2.64 There are also a number of weaknesses to the transactional net margin method. The net profit indicator of a taxpayer can be influenced by some factors that would either not have an effect, or have a less substantial or direct effect, on price or gross margins between independent parties. These aspects may make accurate and reliable determinations of arm’s length net profit indicators difficult. Thus, it is important to provide some detailed guidance on establishing comparability for the transactional net margin method, as set forth in paragraphs 2.68-2.75 below.

2.65 Application of any arm’s length method requires information on uncontrolled transactions that may not be available at the time of the controlled transactions. This may make it particularly difficult for taxpayers that attempt to apply the transactional net margin method at the time of the controlled transactions (although use of multiple year data as discussed in paragraphs 3.75-3.79 may mitigate this concern). In addition, taxpayers may not have access to enough specific information on the profits attributable to comparable uncontrolled transactions to make a valid application of the method. It also may be difficult to ascertain revenue and operating expenses related to the controlled transactions to establish the net profit indicator used as the profit measure for the transactions. Tax administrators may have more information available to them from examinations of other taxpayers. See paragraph 3.36 for a discussion of

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<sup>1</sup> An example illustrating the sensitivity of gross and net profit margin indicators is found in Annex I to Chapter II.

information available to tax administrators that may not be disclosed to the taxpayer, and paragraphs 3.67-3.79 for a discussion of timing issues.

2.66 Like the resale price and cost plus methods, the transactional net margin method is applied to only one of the associated enterprises. The fact that many factors unrelated to transfer prices may affect net profits, in conjunction with the one-sided nature of the analysis under this method, can affect the overall reliability of the transactional net margin method if an insufficient standard of comparability is applied. Detailed guidance on establishing comparability for the transactional net margin method is given in section B.3.1 below.

2.67 There may also be difficulties in determining an appropriate corresponding adjustment when applying the transactional net margin method, particularly where it is not possible to work back to a transfer price. This could be the case, for example, where the taxpayer deals with associated enterprises on both the buying and the selling sides of the controlled transaction. In such a case, if the transactional net margin method indicates that the taxpayer's profit should be adjusted upwards, there may be some uncertainty about which of the associated enterprises' profits should be reduced.

### **B.3 Guidance for application**

#### *B.3.1 The comparability standard to be applied to the transactional net margin method*

2.68 A comparability analysis must be performed in all cases in order to select and apply the most appropriate transfer pricing method, and the process for selecting and applying a transactional net margin method should not be less reliable than for other methods. As a matter of good practice, the typical process for identifying comparable transactions and using data so obtained which is described at paragraph 3.4 or any equivalent process designed to ensure robustness of the analysis should be followed when applying a transactional net margin method, just as with any other method. That being said, it is recognised that in practice the level of information available on the factors affecting external comparable transactions is often limited. Determining a reliable estimate of an arm's length outcome requires flexibility and the exercise of good judgment. See paragraph 1.13.

2.69 Prices are likely to be affected by differences in products, and gross margins are likely to be affected by differences in functions, but net profit indicators are less adversely affected by such differences. As with the resale price and cost plus methods that the transactional net margin method resembles, this, however, does not mean that a mere similarity of functions between two enterprises will necessarily lead to reliable comparisons. Assuming similar functions can be isolated from among the wide range of functions that enterprises may exercise, in order to apply the method, the net profit indicators related to such functions may still not be automatically comparable where, for instance, the enterprises concerned carry on those functions in different economic sectors or markets with different levels of profitability. When the comparable uncontrolled transactions being used are those of an independent enterprise, a high degree of similarity is required in a number of aspects of the associated enterprise and the independent enterprise involved in the transactions in order for the controlled transactions to be comparable; there are various factors other than products and functions that can significantly influence net profit indicators.

2.70 The use of net profit indicators can potentially introduce a greater element of volatility into the determination of transfer prices for two reasons. First, net profit indicators can be influenced by some factors that do not have an effect (or have a less substantial or direct effect) on gross margins and prices, because of the potential for variation of operating expenses across enterprises. Second, net profit indicators can be influenced by some of the same factors, such as competitive position, that can influence price and gross margins, but the effect of these factors may not be as readily eliminated. In the traditional

transaction methods, the effect of these factors may be eliminated as a natural consequence of insisting upon greater product and function similarity. Depending on the facts and circumstances of the case and in particular on the effect of the functional differences on the cost structure and on the revenue of the potential comparables, net profit indicators can be less sensitive than gross margins to differences in the extent and complexity of functions and to differences in the level of risks (assuming the contractual allocation of risks is arm's length). On the other hand, depending on the facts and circumstances of the case and in particular on the proportion of fixed and variable costs, the transactional net margin method may be more sensitive than the cost plus or resale price methods to differences in capacity utilisation, because differences in the levels of absorption of indirect fixed costs (*e.g.* fixed manufacturing costs or fixed distribution costs) would affect the net profit indicator but may not affect the gross margin or gross mark-up on costs if not reflected in price differences. See Annex I to Chapter II "Sensitivity of gross and net profit indicators".

2.71 Net profit indicators may be directly affected by such forces operating in the industry as follows: threat of new entrants, competitive position, management efficiency and individual strategies, threat of substitute products, varying cost structures (as reflected, for example, in the age of plant and equipment), differences in the cost of capital (*e.g.* self financing versus borrowing), and the degree of business experience (*e.g.* whether the business is in a start-up phase or is mature). Each of these factors in turn can be influenced by numerous other elements. For example, the level of the threat of new entrants will be determined by such elements as product differentiation, capital requirements, and government subsidies and regulations. Some of these elements also may impact the application of the traditional transaction methods.

2.72 Assume, for example, that a taxpayer sells top quality audio players to an associated enterprise, and the only profit information available on comparable business activities is on generic medium quality audio player sales. Assume that the top quality audio player market is growing in its sales, has a high entry barrier, has a small number of competitors, and is with wide possibilities for product differentiation. All of the differences are likely to have material effect on the profitability of the examined activities and compared activities, and in such a case would require adjustment. As with other methods, the reliability of the necessary adjustments will affect the reliability of the analysis. It should be noted that even if two enterprises are in exactly the same industry, the profitability may differ depending on their market shares, competitive positions, etc.

2.73 It might be argued that the potential inaccuracies resulting from the above types of factors can be reflected in the size of the arm's length range. The use of a range may to some extent mitigate the level of inaccuracy, but may not account for situations where a taxpayer's profits are increased or reduced by a factor unique to that taxpayer. In such a case, the range may not include points representing the profits of independent enterprises that are affected in a similar manner by a unique factor. The use of a range, therefore, may not always solve the difficulties discussed above. See discussion of arm's length ranges at paragraphs 3.55-3.66.

2.74 The transactional net margin method may afford a practical solution to otherwise insoluble transfer pricing problems if it is used sensibly and with appropriate adjustments to account for differences of the type referred to above. The transactional net margin method should not be used unless the net profit indicators are determined from uncontrolled transactions of the same taxpayer in comparable circumstances or, where the comparable uncontrolled transactions are those of an independent enterprise, the differences between the associated enterprises and the independent enterprises that have a material effect on the net profit indicator being used are adequately taken into account. Many countries are concerned that the safeguards established for the traditional transaction methods may be overlooked in applying the transactional net margin method. Thus where differences in the characteristics of the enterprises being compared have a material effect on the net profit indicators being used, it would not be

appropriate to apply the transactional net margin method without making adjustments for such differences. The extent and reliability of those adjustments will affect the relative reliability of the analysis under the transactional net margin method. See discussion of comparability adjustments at paragraphs 3.47-3.54.

2.75 Another important aspect of comparability is measurement consistency. The net profit indicators must be measured consistently between the associated enterprise and the independent enterprise. In addition, there may be differences in the treatment across enterprises of operating expenses and non-operating expenses affecting the net profits such as depreciation and reserves or provisions that would need to be accounted for in order to achieve reliable comparability.

### *B.3.2 Selection of the net profit indicator*

2.76 In applying the transactional net margin method, the selection of the most appropriate net profit indicator should follow the guidance at paragraphs 2.2 and 2.8 in relation to the selection of the most appropriate method to the circumstances of the case. It should take account of the respective strengths and weaknesses of the various possible indicators; the appropriateness of the indicator considered in view of the nature of the controlled transaction, determined in particular through a functional analysis; the availability of reliable information (in particular on uncontrolled comparables) needed to apply the transactional net margin method based on that indicator; and the degree of comparability between controlled and uncontrolled transactions, including the reliability of comparability adjustments that may be needed to eliminate differences between them, when applying the transactional net margin method based on that indicator. These factors are discussed below in relation to both the determination of the net profit and its weighting.

### *B.3.3 Determination of the net profit*

2.77 As a matter of principle, only those items that (a) directly or indirectly relate to the controlled transaction at hand and (b) are of an operating nature should be taken into account in the determination of the net profit indicator for the application of the transactional net margin method.

2.78 Costs and revenues that are not related to the controlled transaction under review should be excluded where they materially affect comparability with uncontrolled transactions. An appropriate level of segmentation of the taxpayer's financial data is needed when determining or testing the net profit it earns from a controlled transaction (or from transactions that are appropriately aggregated according to the guidance at paragraphs 3.9-3.12). Therefore, it would be inappropriate to apply the transactional net margin method on a company-wide basis if the company engages in a variety of different controlled transactions that cannot be appropriately compared on an aggregate basis with those of an independent enterprise.

2.79 Similarly, when analysing the transactions between the independent enterprises to the extent they are needed, profits attributable to transactions that are not similar to the controlled transactions under examination should be excluded from the comparison. Finally, when net profit indicators of an independent enterprise are used, the profits attributable to the transactions of the independent enterprise must not be distorted by controlled transactions of that enterprise. See paragraphs 3.9-3.12 on the evaluation of a taxpayer's separate and combined transactions and paragraph 3.37 on the use of non-transactional third party data.

2.80 Non-operating items such as interest income and expenses and income taxes should be excluded from the determination of the net profit indicator. Exceptional and extraordinary items of a non-recurring nature should generally also be excluded. This however is not always the case as there may be situations where it would be appropriate to include them, depending on the circumstances of the case and on the

functions being undertaken and risks being borne by the tested party. Even where exceptional and extraordinary items are not taken into account in the determination of the net profit indicator, it may be useful to review them because they can provide valuable information for the purpose of comparability analysis (for instance by reflecting that the tested party bears a given risk).

2.81 In those cases where there is a correlation between the credit terms and the sales prices, it could be appropriate to reflect interest income in respect of short-term working capital within the calculation of the net profit indicator and/or to proceed with a working capital adjustment, see paragraphs 3.47-3.54. An example would be where a large retail business benefits from long credit terms with its suppliers and from short credit terms with its customers, thus making it possible to derive excess cash that in turn may make it possible to have lower sales prices to customers than if such advantageous credit terms were not available.

2.82 Whether foreign exchange gains and losses should be included or excluded from the determination of the net profit indicator raises a number of difficult comparability issues. First, it needs to be considered whether the foreign exchange gains and losses are of a trading nature (*e.g.* exchange gain or loss on a trade receivable or payable) and whether or not the tested party is responsible for them. Second, any hedging of the foreign currency exposure on the underlying trade receivable or payable also needs to be considered and treated in the same way in determining the net profit. In effect, if a transactional net margin is applied to a transaction in which the foreign exchange risk is borne by the tested party, foreign exchange gains or losses should be consistently accounted for (either in the calculation of the net profit indicator or separately).

2.83 For financial activities where the making and receiving of advances constitutes the ordinary business of the taxpayer, it will generally be appropriate to consider the effect of interest and amounts in the nature of interest when determining the net profit indicator.

2.84 Difficult comparability issues can arise where the accounting treatment of some items by potential third party comparables is unclear or does not allow reliable measurement or adjustment (see paragraph 2.75). This can be the case in particular for depreciation, amortisation, stock option and pension costs. The decision whether or not to include such items in the determination of the net profit indicator for applying the transactional net margin method will depend on a weighing of their expected effects on the appropriateness of the net profit indicator to the circumstances of the transaction and on the reliability of the comparison (see paragraph 3.50).

2.85 Whether start-up costs and termination costs should be included in the determination of the net profit indicator depends on the facts and circumstances of the case and on whether in comparable circumstances, independent parties would have agreed either for the party performing the functions to bear the start-up costs and possible termination costs; or for part or all of these costs to be recharged with no mark-up, *e.g.* to the customer or a principal; or for part or all of these costs to be recharged with a mark-up, *e.g.* by including them in the calculation of the net profit indicator of the party performing the functions. See Chapter IX, Part II, Section E for a discussion of termination costs in the context of a business restructuring.

#### *B.3.4 Weighting the net profit*

2.86 The selection of the denominator should be consistent with the comparability (including functional) analysis of the controlled transaction, and in particular it should reflect the allocation of risks between the parties (provided said allocation of risks is arm's length, see paragraphs 1.47-1.50). For instance, capital-intensive activities such as certain manufacturing activities may involve significant investment risk, even in those cases where the operational risks (such as market risks or inventory risks) might be limited. Where a transactional net margin method is applied to such cases, the investment-related

risks are reflected in the net profit indicator if the latter is a return on investment (*e.g.* return on assets or return on capital employed). Such indicator might need to be adjusted (or a different net profit indicator selected) depending on what party to the controlled transaction bears that risk, as well as on the degree of differences in risk that may be found in the taxpayer's controlled transaction and in comparables. See paragraphs 3.47-3.54 for a discussion of comparability adjustments.

2.87 The denominator should be focussed on the relevant indicator(s) of the value of the functions performed by the tested party in the transaction under review, taking account of its assets used and risks assumed. Typically, and subject to a review of the facts and circumstances of the case, sales or distribution operating expenses may be an appropriate base for distribution activities, full costs or operating expenses may be an appropriate base for a service or manufacturing activity, and operating assets may be an appropriate base for capital-intensive activities such as certain manufacturing activities or utilities. Other bases can also be appropriate depending on the circumstances of the case.

2.88 The denominator should be reasonably independent from controlled transactions, otherwise there would be no objective starting point. For instance, when analysing a transaction consisting in the purchase of goods by a distributor from an associated enterprise for resale to independent customers, one could not weight the net profit indicator against the cost of goods sold because these costs are the controlled costs for which consistency with the arm's length principle is being tested. Similarly, for a controlled transaction consisting in the provision of services to an associated enterprise, one could not weight the net profit indicator against the revenue from the sale of services because these are the controlled sales for which consistency with the arm's length principle is being tested. Where the denominator is materially affected by controlled transaction costs that are not the object of the testing (such as head office charges, rental fees or royalties paid to an associated enterprise), caution should be exercised to ensure that said controlled transaction costs do not materially distort the analysis and in particular that they are in accordance with the arm's length principle.

2.89 The denominator should be one that is capable of being measured in a reliable and consistent manner at the level of the taxpayer's controlled transactions. In addition, the appropriate base should be one that is capable of being measured in a reliable and consistent manner at the level of the comparable uncontrolled transactions. This in practice limits the ability to use certain indicators, as discussed at paragraph 2.99 below. Further, the taxpayer's allocation of indirect expenses to the transaction under review should be appropriate and consistent over time.

#### B.3.4.1 Cases where the net profit is weighted to sales

2.90 A net profit indicator of net profit divided by sales, or net profit margin, is frequently used to determine the arm's length price of purchases from an associated enterprise for resale to independent customers. In such cases, the sales figure at the denominator should be the re-sales of items purchased in the controlled transaction under review. Sales revenue that is derived from uncontrolled activities (purchase from independent parties for re-sale to independent parties) should not be included in the determination or testing of the remuneration for controlled transactions, unless the uncontrolled transactions are such that they do not materially affect the comparison; and/or the controlled and uncontrolled transactions are so closely linked that they cannot be evaluated adequately on a separate basis. One example of the latter situation can sometimes occur in relation to uncontrolled after-sales services or sales of spare parts provided by a distributor to independent end-user customers where they are closely linked to controlled purchase transactions by the distributor for resale to the same independent end-user customers, for instance because the service activity is performed using rights or other assets that are granted under the distribution arrangement. See also discussion of portfolio approaches in paragraph 3.10.

2.91 One question that arises in cases where the net profit indicator is weighted against sales is how to account for rebates and discounts that may be granted to customers by the taxpayer or the comparables. Depending on the accounting standards, rebates and discounts may be treated as a reduction of sales revenue or as an expense. Similar difficulties can arise in relation to foreign exchange gains or losses. Where such items materially affect the comparison, the key is to compare like with like and follow the same accounting principles for the taxpayer and for the comparables.

#### B.3.4.2 Cases where the net profit is weighted to costs

2.92 Cost-based indicators should only be used in those cases where costs are a relevant indicator of the value of the functions performed, assets used and risks assumed by the tested party. In addition, the determination of what costs should be included in the cost base should derive from a careful review of the facts and circumstances of the case. Where the net profit indicator is weighted against costs, only those costs that directly or indirectly relate to the controlled transaction under review (or transactions aggregated in accordance to the principle at paragraphs 3.9-3.12) should be taken into account. Accordingly, an appropriate level of segmentation of a taxpayer's accounts is needed in order to exclude from the denominator costs that relate to other activities or transactions and materially affect comparability with uncontrolled transactions. Moreover, in most cases only those costs which are of an operating nature should be included in the denominator. The discussion at paragraphs 2.80-2.85 above also applies to costs as denominator.

2.93 In applying a cost-based transactional net margin method, fully loaded costs are often used, including all the direct and indirect costs attributable to the activity or transaction, together with an appropriate allocation in respect of the overheads of the business. The question can arise whether and to what extent it is acceptable at arm's length to treat a significant portion of the taxpayer's costs as pass-through costs to which no profit element is attributed (*i.e.* as costs which are potentially excludable from the denominator of the net profit indicator). This depends on the extent to which an independent party in comparable circumstances would agree not to earn a mark-up on part of the costs it incurs. The response should not be based on the classification of costs as "internal" or "external" costs, but rather on a comparability (including functional) analysis. See paragraph 7.36.

2.94 Where treating costs as pass-through costs is found to be arm's length, a second question arises as to the consequences on comparability and on the determination of the arm's length range. Because it is necessary to compare like with like, if pass-through costs are excluded from the denominator of the taxpayer's net profit indicator, comparable costs should also be excluded from the denominator of the comparable net profit indicator. Comparability issues may arise in practice where limited information is available on the breakdown of the costs of the comparables.

2.95 Depending on the facts and circumstances of the case, actual costs, as well as standard or budgeted costs, may be appropriate to use as the cost base. Using actual costs may raise an issue because the tested party may have no incentive to carefully monitor the costs. In arrangements between independent parties, it is not rare that a cost savings objective is factored into the remuneration method. It can also happen in manufacturing arrangements between independent parties that prices are set on the basis of standard costs, and that any decrease or increase in actual costs compared to standard costs is attributed to the manufacturer. Where they reflect the arrangements that would be taken between independent parties, similar mechanisms could be taken into account in the application of the cost-based transactional net margin method. See paragraph 2.52 for a discussion of the same issue in relation to the cost plus method.

2.96 The use of budgeted costs can also raise a number of concerns where large differences between actual costs and budgeted costs result. Independent parties are not likely to set prices on the basis of budgeted costs without agreeing on what factors are to be taken into account in setting the budget, without

having regard to how budgeted costs have compared with actual costs in previous years and without addressing how unforeseen circumstances are to be treated.

#### B.3.4.3 Cases where the net profit is weighted to assets

2.97 Returns on assets (or on capital) can be an appropriate base in cases where assets (rather than costs or sales) are a better indicator of the value added by the tested party, *e.g.* in certain manufacturing or other asset-intensive activities and in capital-intensive financial activities. Where the indicator is a net profit weighted to assets, operating assets only should be used. Operating assets include tangible operating fixed assets, including land and buildings, plant and equipment, operating intangible assets used in the business, such as patents and know-how, and working capital assets such as inventory and trade receivables (less trade payables). Investments and cash balances are generally not operating assets outside the financial industry sector.

2.98 In cases where the net profit is weighted to assets, the question arises how to value the assets, *e.g.* at book value or market value. Using book value could possibly distort the comparison, *e.g.* between those enterprises that have depreciated their assets and those that have more recent assets with on-going depreciation, and between enterprises that use acquired intangibles and others that use self-developed intangibles. Using market value could possibly alleviate this concern, although it can raise other reliability issues where valuation of assets is uncertain and can also prove to be extremely costly and burdensome, especially for intangible assets. Depending on the facts and circumstances of the case, it may be possible to perform adjustments to improve the reliability of the comparison. The choice between book value, adjusted book value, market value and other possibly available options should be made with a view to finding the most reliable measure, taking account of the size and complexity of the transaction and of the costs and burden involved, see Chapter III, Section C.

#### B.3.4.4 Other possible net profit indicators

2.99 Other net profit indicators may be appropriate depending on the facts and circumstances of the transactions. For instance, depending on the industry and on the controlled transaction under review, it may be useful to look at other denominators where independent data may exist, such as: floor area of retail points, weight of products transported, number of employees, time, distance, etc. While there is no reason to rule out the use of such bases where they provide a reasonable indication of the value added by the tested party to the controlled transaction, they should only be used where it is possible to obtain reliable comparable information to support the application of the method with such a net profit indicator.

#### B.3.5 Berry ratios

2.100 “Berry ratios” are defined as ratios of gross profit to operating expenses. Interest and extraneous income are generally excluded from the gross profit determination; depreciation and amortisation may or may not be included in the operating expenses, depending in particular on the possible uncertainties they can create in relation to valuation and comparability.

2.101 The selection of the appropriate financial indicator depends on the facts and circumstances of the case, see paragraph 2.76. Concerns have been expressed that Berry ratios are sometimes used in cases where they are not appropriate without the caution that is necessary in the selection and determination of any transfer pricing method and financial indicator. See paragraph 2.92 in relation to the use of cost-based indicators in general. One common difficulty in the determination of Berry ratios is that they are very sensitive to classification of costs as operating expenses or not, and therefore can pose comparability issues. In addition, the issues raised at paragraphs 2.93-2.94 above in relation to pass-through costs equally

arise in the application of Berry ratios. In order for a Berry ratio to be appropriate to test the remuneration of a controlled transaction (*e.g.* consisting in the distribution of products), it is necessary that:

- The value of the functions performed in the controlled transaction (taking account of assets used and risks assumed) is proportional to the operating expenses,
- The value of the functions performed in the controlled transaction (taking account of assets used and risks assumed) is not materially affected by the value of the products distributed, *i.e.* it is not proportional to sales, and
- The taxpayer does not perform, in the controlled transactions, any other significant function (*e.g.* manufacturing function) that should be remunerated using another method or financial indicator.

2.102 A situation where Berry ratios can prove useful is for intermediary activities where a taxpayer purchases goods from an associated enterprise and on-sells them to other associated enterprises. In such cases, the resale price method may not be applicable given the absence of uncontrolled sales, and a cost plus method that would provide for a mark-up on the cost of goods sold might not be applicable either where the cost of goods sold consists in controlled purchases. By contrast, operating expenses in the case of an intermediary may be reasonably independent from transfer pricing formulation, unless they are materially affected by controlled transaction costs such as head office charges, rental fees or royalties paid to an associated enterprise, so that, depending on the facts and circumstances of the case, a Berry ratio may be an appropriate indicator, subject to the comments above.

#### *B.3.6 Other guidance*

2.103 While it is not specific to the transactional net margin method, the issue of the use of non-transactional third party data is in practice more acute when applying this method due to the heavy reliance on external comparables. The problem arises because there are often insufficient public data to allow for third party net profit indicators to be determined at transactional level. This is why there needs to be sufficient comparability between the controlled transaction and the comparable uncontrolled transactions. Given that often the only data available for the third parties are company-wide data, the functions performed by the third party in its total operations must be closely aligned to those functions performed by the tested party with respect to its controlled transactions in order to allow the former to be used to determine an arm's length outcome for the latter. The overall objective is to determine a level of segmentation that provides reliable comparables for the controlled transaction, based on the facts and circumstances of the particular case. In case it is impossible in practice to achieve the transactional level set out as the ideal by these Guidelines, it is still important to try to find the most reliable comparables as discussed at paragraph 3.2, through making suitable adjustments based on the evidence that is available.

2.104 See in particular paragraphs 3.18-3.19 for guidance on the tested party, paragraphs 3.55-3.66 for guidance on the arm's length range, and paragraphs 3.75-3.79 for guidance on multiple year data.

#### ***B.4 Examples of the application of the transactional net margin method***

2.105 By way of illustration, the example of cost plus at paragraph 2.53 demonstrates the need to adjust the gross mark up arising from transactions in order to achieve consistent and reliable comparison. Such adjustments may be made without difficulty where the relevant costs can be readily analyzed. Where, however, it is known that an adjustment is required, but it is not possible to identify the particular costs for which an adjustment is required, it may, nevertheless, be possible to identify the net profit arising on the transaction and thereby ensure that a consistent measure is used. For example, if the supervisory, general,

and administrative costs that are treated as part of costs of goods sold for the independent enterprises X, Y and Z cannot be identified so as to adjust the mark up in a reliable application of cost plus, it may be necessary to examine net profit indicators in the absence of more reliable comparisons.

2.106 A similar approach may be required when there are differences in functions performed by the parties being compared. Assume that the facts are the same as in the example at paragraph 2.38 except that it is the comparable independent enterprises that perform the additional function of technical support and not the associated enterprise, and that these costs are reported in the cost of goods sold but cannot be separately identified. Because of product and market differences it may not be possible to find a CUP, and a resale price method would be unreliable since the gross margin of the independent enterprises would need to be higher than that of the associated enterprise in order to reflect the additional function and to cover the unknown additional costs. In this example, it may be more reliable to examine net margins in order to assess the difference in the transfer price that would reflect the difference in function. The use of net margins in such a case needs to take account of comparability and may not be reliable if there would be a material effect on net margin as a result of the additional function or as a result of market differences.

2.107 The facts are the same as in paragraph 2.36. However, the amount of the warranty expenses incurred by Distributor A proves impossible to ascertain so that it is not possible to reliably adjust the gross profit of A to make the gross profit margin properly comparable with that of B. However, if there are no other material functional differences between A and B and the net profit of A relative to its sales is known, it might be possible to apply the transactional net margin method to B by comparing the margin relative to A's sales to net profits with the margin calculated on the same basis for B.

## **C. Transactional profit split method**

### ***C.1 In general***

2.108 The transactional profit split method seeks to eliminate the effect on profits of special conditions made or imposed in a controlled transaction (or in controlled transactions that are appropriate to aggregate under the principles of paragraphs 3.9-3.12) by determining the division of profits that independent enterprises would have expected to realise from engaging in the transaction or transactions. The transactional profit split method first identifies the profits to be split for the associated enterprises from the controlled transactions in which the associated enterprises are engaged (the "combined profits"). References to "profits" should be taken as applying equally to losses. See paragraphs 2.124-2.131 for a discussion of how to measure the profits to be split. It then splits those combined profits between the associated enterprises on an economically valid basis that approximates the division of profits that would have been anticipated and reflected in an agreement made at arm's length. See paragraphs 2.132 -2.145 for a discussion of how to split the combined profits.

### ***C.2 Strengths and weaknesses***

2.109 The main strength of the transactional profit split method is that it can offer a solution for highly integrated operations for which a one-sided method would not be appropriate. For example, see the discussion of the appropriateness and application of profit split methods to the global trading of financial instruments between associated enterprises in Part III, Section C of the Report on the Attribution of Profits to Permanent Establishments.<sup>2</sup> A transactional profit split method may also be found to be the most

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<sup>2</sup> See Report on the Attribution of Profits to Permanent Establishments, approved by the Committee on Fiscal Affairs on 24 June 2008 and by the Council for publication on 17 July 2008 and the 2010 Sanitised Version of the Report on the Attribution of Profits to Permanent Establishments, approved by the Committee on Fiscal Affairs on 22 June 2010 and by the Council for publication on 22 July 2010.

appropriate method in cases where both parties to a transaction make unique and valuable contributions (e.g. contribute unique intangibles) to the transaction, because in such a case independent parties might wish to share the profits of the transaction in proportion to their respective contributions and a two-sided method might be more appropriate in these circumstances than a one-sided method. In addition, in the presence of unique and valuable contributions, reliable comparables information might be insufficient to apply another method. On the other hand, a transactional profit split method would ordinarily not be used in cases where one party to the transaction performs only simple functions and does not make any significant unique contribution (e.g. contract manufacturing or contract service activities in relevant circumstances), as in such cases a transactional profit split method typically would not be appropriate in view of the functional analysis of that party. See paragraphs 3.38-3.39 for a discussion of limitations in available comparables.

2.110 Where comparables data are available, they can be relevant in the profit split analysis to support the division of profits that would have been achieved between independent parties in comparable circumstances. Comparables data can also be relevant in the profit split analysis to assess the value of the contributions that each associated enterprise makes to the transactions. In effect, the assumption is that independent parties would have split the combined profits in proportion to the value of their respective contributions to the generation of profit in the transaction. On the other hand, the external market data considered in valuing the contribution each associated enterprise makes to the controlled transactions will be less closely connected to those transactions than is the case with the other available methods.

2.111 However, in those cases where there is no more direct evidence of how independent parties in comparable circumstances would have split the profit in comparable transactions, the allocation of profits may be based on the division of functions (taking account of the assets used and risks assumed) between the associated enterprises themselves.

2.112 Another strength of the transactional profit split method is that it offers flexibility by taking into account specific, possibly unique, facts and circumstances of the associated enterprises that are not present in independent enterprises, while still constituting an arm's length approach to the extent that it reflects what independent enterprises reasonably would have done if faced with the same circumstances.

2.113 A further strength of the transactional profit split method is that it is less likely that either party to the controlled transaction will be left with an extreme and improbable profit result, since both parties to the transaction are evaluated. This aspect can be particularly important when analysing the contributions by the parties in respect of the intangible property employed in the controlled transactions. This two-sided approach may also be used to achieve a division of the profits from economies of scale or other joint efficiencies that satisfies both the taxpayer and tax administrations.

2.114 A weakness of the transactional profit split method relates to difficulties in its application. On first review, the transactional profit split method may appear readily accessible to both taxpayers and tax administrations because it tends to rely less on information about independent enterprises. However, associated enterprises and tax administrations alike may have difficulty accessing information from foreign affiliates. In addition, it may be difficult to measure combined revenue and costs for all the associated enterprises participating in the controlled transactions, which would require stating books and records on a common basis and making adjustments in accounting practices and currencies. Further, when the transactional profit split method is applied to operating profit, it may be difficult to identify the appropriate operating expenses associated with the transactions and to allocate costs between the transactions and the associated enterprises' other activities.

### C.3 *Guidance for application*

#### C.3.1 *In general*

2.115 These Guidelines do not seek to provide an exhaustive catalogue of ways in which the transactional profit split method may be applied. Application of the method will depend on the circumstances of the case and the information available, but the overriding objective should be to approximate as closely as possible the split of profits that would have been realised had the parties been independent enterprises.

2.116 Under the transactional profit split method, the combined profits are to be split between the associated enterprises on an economically valid basis that approximates the division of profits that would have been anticipated and reflected in an agreement made at arm's length. In general, the determination of the combined profits to be split and of the splitting factors should:

- Be consistent with the functional analysis of the controlled transaction under review, and in particular reflect the allocation of risks among the parties,
- Be consistent with the determination of the combined profits to be split and of the splitting factors which would have been agreed between independent parties,
- Be consistent with the type of profit split approach (*e.g.* contribution analysis, residual analysis, or other; *ex ante* or *ex post* approach, as discussed at paragraphs 2.118-2.145 below), and
- Be capable of being measured in a reliable manner.

2.117 In addition,

- If a transactional profit split method is used to set transfer pricing in controlled transactions (*ex ante* approach), it would be reasonable to expect the life-time of the arrangement and the criteria or allocation keys to be agreed in advance of the transaction,
- The person using a transactional profit split method (taxpayer or tax administration) should be prepared to explain why it is regarded as the most appropriate method to the circumstances of the case, as well as the way it is implemented, and in particular the criteria or allocation keys used to split the combined profits, and
- The determination of the combined profits to be split and of the splitting factors should generally be used consistently over the life-time of the arrangement, including during loss years, unless independent parties in comparable circumstances would have agreed otherwise and the rationale for using differing criteria or allocation keys is documented, or if specific circumstances would have justified a re-negotiation between independent parties.

#### C.3.2 *Various approaches for splitting the profits*

2.118 There are a number of approaches for estimating the division of profits, based on either projected or actual profits, as may be appropriate, to which independent enterprises would have agreed, two of which are discussed in the following paragraphs. These approaches – contribution analysis and residual analysis – are not necessarily exhaustive or mutually exclusive.

### C.3.2.1 Contribution analysis

2.119 Under a contribution analysis, the combined profits, which are the total profits from the controlled transactions under examination, would be divided between the associated enterprises based upon a reasonable approximation of the division of profits that independent enterprises would have expected to realize from engaging in comparable transactions. This division can be supported by comparables data where available. In the absence thereof, it is often based on the relative value of the functions performed by each of the associated enterprises participating in the controlled transactions, taking account of their assets used and risks assumed. In cases where the relative value of the contributions can be measured directly, it may not be necessary to estimate the actual market value of each participant's contributions.

2.120 It can be difficult to determine the relative value of the contribution that each of the associated enterprises makes to the controlled transactions, and the approach will often depend on the facts and circumstances of each case. The determination might be made by comparing the nature and degree of each party's contribution of differing types (for example, provision of services, development expenses incurred, capital invested) and assigning a percentage based upon the relative comparison and external market data. See paragraphs 2.132-2.145 for a discussion of how to split the combined profits.

### C.3.2.2 Residual analyses<sup>3</sup>

2.121 A residual analysis divides the combined profits from the controlled transactions under examination in two stages. In the first stage, each participant is allocated an arm's length remuneration for its non-unique contributions in relation to the controlled transactions in which it is engaged. Ordinarily this initial remuneration would be determined by applying one of the traditional transaction methods or a transactional net margin method, by reference to the remuneration of comparable transactions between independent enterprises. Thus, it would generally not account for the return that would be generated by any unique and valuable contribution by the participants. In the second stage, any residual profit (or loss) remaining after the first stage division would be allocated among the parties based on an analysis of the facts and circumstances, following the guidance as described at paragraphs 2.132-2.145 for splitting the combined profits.

2.122 An alternative approach to how to apply a residual analysis could seek to replicate the outcome of bargaining between independent enterprises in the free market. In this context, in the first stage, the initial remuneration provided to each participant would correspond to the lowest price an independent seller reasonably would accept in the circumstances and the highest price that the buyer would be reasonably willing to pay. Any discrepancy between these two figures could result in the residual profit over which independent enterprises would bargain. In the second stage, the residual analysis therefore could divide this pool of profit based on an analysis of any factors relevant to the associated enterprises that would indicate how independent enterprises might have split the difference between the seller's minimum price and the buyer's maximum price.

2.123 In some cases an analysis could be performed, perhaps as part of a residual profit split or as a method of splitting profits in its own right, by taking into account the discounted cash flow to the parties to the controlled transactions over the anticipated life of the business. One of the situations in which this may be an effective method could be where a start-up is involved, cash flow projections were carried out as part of assessing the viability of the project, and capital investment and sales could be estimated with a reasonable degree of certainty. However, the reliability of such an approach will depend on the use of an appropriate discount rate, which should be based on market benchmarks. In this regard, it should be noted that industry-wide risk premiums used to calculate the discount do not distinguish between particular

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<sup>3</sup> An example illustrating the application of the residual profit split is found in Annex II to Chapter II.

companies let alone segments of businesses, and estimates of the relative timing of receipts can be problematic. Such an approach, therefore, would require considerable caution and should be supplemented where possible by information derived from other methods.

### C.3.3 Determining the combined profits to be split

2.124 The combined profits to be split in a transactional profit split method are the profits of the associated enterprises from the controlled transactions in which the associated enterprises are engaged. The combined profits to be split should only be those arising from the controlled transaction(s) under review. In determining those profits, it is essential to first identify the relevant transactions to be covered by the transactional profit split. It is also essential to identify the level of aggregation, see paragraphs 3.9-3.12. Where a taxpayer has controlled transactions with more than one associated enterprise, it is also necessary to identify the parties in relation to those transactions and the profits to be split among them.

2.125 In order to determine the combined profits to be split, the accounts of the parties to the transaction to which a transactional profit split is applied need to be put on a common basis as to accounting practice and currency, and then combined. Because accounting standards can have significant effects on the determination of the profits to be split, accounting standards should be selected in advance of applying the method and applied consistently over the lifetime of the arrangement. See paragraphs 2.115-2.117 for general guidance on the consistency of the determination of the combined profits to be split.

2.126 Financial accounting may provide the starting point for determining the profit to be split in the absence of harmonized tax accounting standards. The use of other financial data (*e.g.* cost accounting) should be permitted where such accounts exist, are reliable, auditable and sufficiently transactional. In this context, product-line income statements or divisional accounts may prove to be the most useful accounting records.

#### C.3.3.1 Actual or projected profits

2.127 If the profit split method were to be used by associated enterprises to set transfer pricing in controlled transactions (*i.e.* an *ex ante* approach), then each associated enterprise would seek to achieve the division of profits that independent enterprises would have expected to realize from engaging in comparable transactions. Depending on the facts and circumstances, profit splits using either actual or projected profits are observed in practice.

2.128 When a tax administration examines the application of the method used *ex ante* to evaluate whether the method has reliably approximated arm's length transfer pricing, it is critical for the tax administration to acknowledge that the taxpayer could not have known what the actual profit experience of the business activity would be at the time that the conditions of the controlled transaction were established. Without such an acknowledgement, the application of the transactional profit split method could penalize or reward a taxpayer by focusing on circumstances that the taxpayer could not reasonably have foreseen. Such an application would be contrary to the arm's length principle, because independent enterprises in similar circumstances could only have relied upon projections and could not have known the actual profit experience. See also paragraph 3.74.

2.129 In using the transactional profit split method to establish the conditions of controlled transactions, the associated enterprises would seek to achieve the division of profit that independent enterprises would have realized. The evaluation of the conditions of the controlled transactions of associated enterprises using a transactional profit split method will be easiest for a tax administration where the associated enterprises have originally determined such conditions on the same basis. The evaluation may then begin

on the same basis to verify whether the division of actual profits is in accordance with the arm's length principle.

2.130 Where the associated enterprises have determined the conditions in their controlled transactions on a basis other than the transactional profit split method, the tax administration would evaluate such conditions on the basis of the actual profit experience of the enterprise. However, care would need to be exercised to ensure that the application of a transactional profit split method is performed in a context that is similar to what the associated enterprises would have experienced, *i.e.* on the basis of information known or reasonably foreseeable by the associated enterprises at the time the transactions were entered into, in order to avoid the use of hindsight. See paragraphs 2.11 and 3.74.

#### C.3.3.2 Different measures of profits<sup>4</sup>

2.131 Generally, the combined profits to be split in a transactional profit split method are operating profits. Applying the transactional profit split in this manner ensures that both income and expenses of the MNE are attributed to the relevant associated enterprise on a consistent basis. However, occasionally, it may be appropriate to carry out a split of gross profits and then deduct the expenses incurred in or attributable to each relevant enterprise (and excluding expenses taken into account in computing gross profits). In such cases, where different analyses are being applied to divide the gross income and the deductions of the MNE among associated enterprises, care must be taken to ensure that the expenses incurred in or attributable to each enterprise are consistent with the activities and risks undertaken there, and that the allocation of gross profits is likewise consistent with the placement of activities and risks. For example, in the case of an MNE that engages in highly integrated worldwide trading operations, involving various types of property, it may be possible to determine the enterprises in which expenses are incurred (or attributed), but not to accurately determine the particular trading activities to which those expenses relate. In such a case, it may be appropriate to split the gross profits from each trading activity and then deduct from the resulting overall gross profits the expenses incurred in or attributable to each enterprise, bearing in mind the caution noted above.

#### C.3.4 How to split the combined profits

##### C.3.4.1 In general

2.132 The relevance of comparable uncontrolled transactions or internal data and the criteria used to achieve an arm's length division of the profits depend on the facts and circumstances of the case. It is therefore not desirable to establish a prescriptive list of criteria or allocation keys. See paragraphs 2.115-2.117 for general guidance on the consistency of the determination of the splitting factors. In addition, the criteria or allocation keys used to split the profit should:

- Be reasonably independent of transfer pricing policy formulation, *i.e.* they should be based on objective data (*e.g.* sales to independent parties), not on data relating to the remuneration of controlled transactions (*e.g.* sales to associated enterprises), and
- Be supported by comparables data, internal data, or both.

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<sup>4</sup> An example illustrating different measures of profits when applying a transactional profit split method can be found in Annex III to Chapter II.

#### C.3.4.2 Reliance on data from comparable uncontrolled transactions

2.133 One possible approach is to split the combined profits based on the division of profits that actually results from comparable uncontrolled transactions. Examples of possible sources of information on uncontrolled transactions that might usefully assist the determination of criteria to split the profits, depending on the facts and circumstances of the case, include joint-venture arrangements between independent parties under which profits are shared, such as development projects in the oil and gas industry; pharmaceutical collaborations, co-marketing or co-promotion agreements; arrangements between independent music record labels and music artists; uncontrolled arrangements in the financial services sector; etc.

#### C.3.4.3 Allocation keys

2.134 In practice, the division of the combined profits under a transactional profit split method is generally achieved using one or more allocation keys. Depending on the facts and circumstances of the case, the allocation key can be a figure (*e.g.* a 30%-70% split based on evidence of a similar split achieved between independent parties in comparable transactions), or a variable (*e.g.* relative value of participant's marketing expenditure or other possible keys as discussed below). Where more than one allocation key is used, it will also be necessary to weight the allocation keys used to determine the relative contribution that each allocation key represents to the earning of the combined profits.

2.135 In practice, allocation keys based on assets/capital (operating assets, fixed assets, intangible assets, capital employed) or costs (relative spending and/or investment in key areas such as research and development, engineering, marketing) are often used. Other allocation keys based for instance on incremental sales, headcounts (number of individuals involved in the key functions that generate value to the transaction), time spent by a certain group of employees if there is a strong correlation between the time spent and the creation of the combined profits, number of servers, data storage, floor area of retail points, etc. may be appropriate depending on the facts and circumstances of the transactions.

##### *Asset-based allocation keys*

2.136 Asset-based or capital-based allocation keys can be used where there is a strong correlation between tangible or intangible assets or capital employed and creation of value in the context of the controlled transaction. See paragraph 2.145 for a brief discussion of splitting the combined profits by reference to capital employed. In order for an allocation key to be meaningful, it should be applied consistently to all the parties to the transaction. See paragraph 2.98 for a discussion of comparability issues in relation to asset valuation in the context of the transactional net margin method, which is also valid in the context of the transactional profit split method.

2.137 One particular circumstance where the transactional profit split method may be found to be the most appropriate method is the case where each party to the transaction contributes valuable, unique intangibles. Intangible assets pose difficult issues in relation both to their identification and to their valuation. Identification of intangibles can be difficult because not all valuable intangible assets are legally protected and registered and not all valuable intangible assets are recorded in the accounts. An essential part of a transactional profit split analysis is to identify what intangible assets are contributed by each associated enterprise to the controlled transaction and their relative value. Guidance on intangible property is found at Chapter VI of these Guidelines. See also the examples in the Annex to Chapter VI "Examples to illustrate the Transfer Pricing Guidelines on intangible property and highly uncertain valuation".

### *Cost-based allocation keys*

2.138 An allocation key based on expenses may be appropriate where it is possible to identify a strong correlation between relative expenses incurred and relative value added. For example, marketing expenses may be an appropriate key for distributors-marketers if advertising generates material marketing intangibles, *e.g.* in consumer goods where the value of marketing intangibles is affected by advertising. Research and development expenses may be suitable for manufacturers if they relate to the development of significant trade intangibles such as patents. However, if, for instance, each party contributes different valuable intangibles, then it is not appropriate to use a cost-based allocation key unless cost is a reliable measure of the relative value of those intangibles. Remuneration is frequently used in situations where people functions are the primary factor in generating the combined profits.

2.139 Cost-based allocation keys have the advantage of simplicity. It is however not always the case that a strong correlation exists between relative expenses and relative value, as discussed in paragraph 6.27. One possible issue with cost-based allocation keys is that they can be very sensitive to accounting classification of costs. It is therefore necessary to clearly identify in advance what costs will be taken into account in the determination of the allocation key and to determine the allocation key consistently among the parties.

### *Timing Issues*

2.140 Another important issue is the determination of the relevant period of time from which the elements of determination of the allocation key (*e.g.* assets, costs, or others) should be taken into account. A difficulty arises because there can be a time lag between the time when expenses are incurred and the time when value is created, and it is sometimes difficult to decide which period's expenses should be used. For example, in the case of a cost-based allocation key, using the expenditure on a single-year basis may be suitable for some cases, while in some other cases it may be more suitable to use accumulated expenditure (net of depreciation or amortization, where appropriate in the circumstances) incurred in the previous as well as the current years. Depending on the facts and circumstances of the case, this determination may have a significant effect on the allocation of profits amongst the parties. As noted at paragraphs 2.116-2.117 above, the selection of the allocation key should be appropriate to the particular circumstances of the case and provide a reliable approximation of the division of profits that would have been agreed between independent parties.

#### C.3.4.4 Reliance on data from the taxpayer's own operations ("internal data")

2.141 Where comparable uncontrolled transactions of sufficient reliability are lacking to support the division of the combined profits, consideration should be given to internal data, which may provide a reliable means of establishing or testing the arm's length nature of the division of profits. The types of such internal data that are relevant will depend on the facts and circumstances of the case and should satisfy the conditions outlined in this Section and in particular at paragraphs 2.116-2.117 and 2.132. They will frequently be extracted from the taxpayers' cost accounting or financial accounting.

2.142 For instance, where an asset-based allocation key is used, it may be based on data extracted from the balance sheets of the parties to the transaction. It will often be the case that not all the assets of the taxpayers relate to the transaction at hand and that accordingly some analytical work is needed for the taxpayer to draw a "transactional" balance sheet that will be used for the application of the transactional profit split method. Similarly, where cost-based allocation keys are used that are based on data extracted from the taxpayers' profit and loss accounts, it may be necessary to draw transactional accounts that identify those expenses that are related to the controlled transaction at hand and those that should be excluded from the determination of the allocation key. The type of expenditure that is taken into account (*e.g.* salaries, depreciation, etc.) as well as the criteria used to determine whether a given expense is related

to the transaction at hand or is rather related to other transactions of the taxpayer (*e.g.* to other lines of products not subject to this profit split determination) should be applied consistently to all the parties to the transaction. See also paragraph 2.98 for a discussion of valuation of assets in the context of the transactional net margin method where the net profit is weighted to assets, which is also relevant to the valuation of assets in the context of a transactional profit split where an asset-based allocation key is used.

2.143 Internal data may also be helpful where the allocation key is based on a cost accounting system, *e.g.* headcounts involved in some aspects of the transaction, time spent by a certain group of employees on certain tasks, number of servers, data storage, floor area of retail points, etc.

2.144 Internal data are essential to assess the values of the respective contributions of the parties to the controlled transaction. The determination of such values should rely on a functional analysis that takes into account all the economically significant functions, assets and risks contributed by the parties to the controlled transaction. In those cases where the profit is split on the basis of an evaluation of the relative importance of the functions, assets and risks to the value added to the controlled transaction, such evaluation should be supported by reliable objective data in order to limit arbitrariness. Particular attention should be given to the identification of the relevant contributions of valuable intangibles and the assumption of significant risks and the importance, relevance and measurement of the factors which gave rise to these valuable intangibles and significant risks.

2.145 One possible approach not discussed above is to split the combined profits so that each of the associated enterprises participating in the controlled transactions earns the same rate of return on the capital it employs in that transaction. This method assumes that each participant's capital investment in the transaction is subject to a similar level of risk, so that one might expect the participants to earn similar rates of return if they were operating in the open market. However, this assumption may not be realistic. For example, it would not account for conditions in capital markets and could ignore other relevant aspects that would be revealed by a functional analysis and that should be taken into account in a transactional profit split.

#### **D. Conclusions on transactional profit methods**

2.146 Paragraphs 2.1-2.11 provide guidance on the selection of the most appropriate transfer pricing method to the circumstances of the case.

2.147 As discussed in these Guidelines, there are concerns regarding the use of the transactional net margin method, in particular that it is sometimes applied without adequately taking into account the relevant differences between the controlled and uncontrolled transactions being compared. Many countries are concerned that the safeguards established for the traditional transaction methods may be overlooked in applying the transactional net margin method. Thus, where differences in the characteristics of the transactions being compared have a material effect on the net profit indicators being used, it would not be appropriate to apply the transactional net margin method without making adjustments for such differences. See paragraphs 2.68-2.75 (the comparability standard to be applied to the transactional net margin method).

2.148 The recognition that the use of transactional profit methods may be necessary is not intended to suggest that independent enterprises would use these methods to set prices. As with any method, it is important that it be possible to calculate appropriate corresponding adjustments when transactional profit methods are used, recognising that in certain cases corresponding adjustments may be determined on an aggregate basis consistent with the aggregation principles in paragraphs 3.9-3.12.

2.149 In all cases, caution must be used to determine whether a transactional profit method as applied to a particular aspect of a case can produce an arm's length answer, either in conjunction with a traditional transaction method or on its own. The question ultimately can be resolved only on a case-by-case basis taking into account the strengths and weaknesses set forth above for a particular transactional profit method to be applied, the comparability (including functional) analysis of the parties to the transaction, and the availability and reliability of comparable data. In addition, these conclusions assume that countries will have a certain degree of sophistication in their underlying tax systems before applying these methods.

## Chapter III

### Comparability Analysis

#### A. Performing a comparability analysis

3.1 General guidance on comparability is found in Section D of Chapter I. By definition, a comparison implies examining two terms: the controlled transaction under review and the uncontrolled transactions that are regarded as potentially comparable. The search for comparables is only part of the comparability analysis. It should be neither confused with nor separated from the comparability analysis. The search for information on potentially comparable uncontrolled transactions and the process of identifying comparables is dependent upon prior analysis of the taxpayer's controlled transaction and of the relevant comparability factors (see paragraphs 1.38-1.63). A methodical, consistent approach should provide some continuity or linkage in the whole analytical process, thereby maintaining a constant relationship amongst the various steps: from the preliminary analysis of the conditions of the controlled transaction, to the selection of the transfer pricing method, through to the identification of potential comparables and ultimately a conclusion about whether the controlled transactions being examined are consistent with the arm's length principle as described in paragraph 1 of Article 9 of the OECD Model Tax Convention.

3.2 As part of the process of selecting the most appropriate transfer pricing method (see paragraph 2.2) and applying it, the comparability analysis always aims at finding the most reliable comparables. Thus, where it is possible to determine that some uncontrolled transactions have a lesser degree of comparability than others, they should be eliminated (see also paragraph 3.56). This does not mean that there is a requirement for an exhaustive search of all possible sources of comparables as it is acknowledged that there are limitations in availability of information and that searches for comparables data can be burdensome. See also discussion of compliance efforts at paragraphs 3.80-3.83.

3.3 In order for the process to be transparent, it is considered a good practice for a taxpayer that uses comparables to support its transfer pricing, or a tax administration that uses comparables to support a transfer pricing adjustment, to provide appropriate supporting information for the other interested party (*i.e.* tax auditor, taxpayer or foreign competent authorities) to be able to assess the reliability of the comparables used. See paragraph 3.36 for a discussion of information available to tax administrations that is not disclosed to taxpayers. General guidance on documentation requirements is found at Chapter V of these Guidelines. See also the Annex to Chapter IV "Guidelines for conducting Advance Pricing Arrangements under the Mutual Agreement Procedure ("MAP APAs")".

#### A.1 Typical process

3.4 Below is a description of a typical process that can be followed when performing a comparability analysis. This process is considered an accepted good practice but it is not a compulsory one, and any other search process leading to the identification of reliable comparables may be acceptable as reliability of the outcome is more important than process (*i.e.* going through the process does not provide any guarantee that the outcome will be arm's length, and not going through the process does not imply that the outcome will not be arm's length).

- Step 1: Determination of years to be covered.
- Step 2: Broad-based analysis of the taxpayer's circumstances.
- Step 3: Understanding the controlled transaction(s) under examination, based in particular on a functional analysis, in order to choose the tested party (where needed), the most appropriate transfer pricing method to the circumstances of the case, the financial indicator that will be tested (in the case of a transactional profit method), and to identify the significant comparability factors that should be taken into account.
- Step 4: Review of existing internal comparables, if any.
- Step 5: Determination of available sources of information on external comparables where such external comparables are needed taking into account their relative reliability.
- Step 6: Selection of the most appropriate transfer pricing method and, depending on the method, determination of the relevant financial indicator (*e.g.* determination of the relevant net profit indicator in case of a transactional net margin method).
- Step 7: Identification of potential comparables: determining the key characteristics to be met by any uncontrolled transaction in order to be regarded as potentially comparable, based on the relevant factors identified in Step 3 and in accordance with the comparability factors set forth at paragraphs 1.38-1.63.
- Step 8: Determination of and making comparability adjustments where appropriate.
- Step 9: Interpretation and use of data collected, determination of the arm's length remuneration.

3.5 In practice, this process is not a linear one. Steps 5 to 7 in particular might need to be carried out repeatedly until a satisfactory conclusion is reached, *i.e.* the most appropriate method is selected, especially because the examination of available sources of information may in some instances influence the selection of the transfer pricing method. For instance, in cases where it is not possible to find information on comparable transactions (step 7) and/or to make reasonably accurate adjustments (step 8), taxpayers might have to select another transfer pricing method and repeat the process starting from step 4.

3.6 See paragraph 3.82 for a discussion of a process to establish, monitor and review transfer prices.

## **A.2 *Broad-based analysis of the taxpayer's circumstances***

3.7 The "broad-based analysis" is an essential step in the comparability analysis. It can be defined as an analysis of the industry, competition, economic and regulatory factors and other elements that affect the taxpayer and its environment, but not yet within the context of looking at the specific transactions in question. This step helps understand the conditions in the taxpayer's controlled transaction as well as those in the uncontrolled transactions to be compared, in particular the economic circumstances of the transaction (see paragraphs 1.55-1.58).

## **A.3 *Review of the controlled transaction and choice of the tested party***

3.8 The review of the controlled transaction(s) under examination aims at identifying the relevant factors that will influence the selection of the tested party (where needed), the selection and application of the most appropriate transfer pricing method to the circumstances of the case, the financial indicator that will be tested (in the case of a transactional profit method), the selection of comparables and where relevant the determination of comparability adjustments.

### *A.3.1 Evaluation of a taxpayer's separate and combined transactions*

3.9 Ideally, in order to arrive at the most precise approximation of arm's length conditions, the arm's length principle should be applied on a transaction-by-transaction basis. However, there are often situations where separate transactions are so closely linked or continuous that they cannot be evaluated adequately on a separate basis. Examples may include *1.* some long-term contracts for the supply of

commodities or services, 2. rights to use intangible property, and 3. pricing a range of closely-linked products (e.g. in a product line) when it is impractical to determine pricing for each individual product or transaction. Another example would be the licensing of manufacturing know-how and the supply of vital components to an associated manufacturer; it may be more reasonable to assess the arm's length terms for the two items together rather than individually. Such transactions should be evaluated together using the most appropriate arm's length method. A further example would be the routing of a transaction through another associated enterprise; it may be more appropriate to consider the transaction of which the routing is a part in its entirety, rather than consider the individual transactions on a separate basis.

3.10 Another example where a taxpayer's transactions may be combined is related to portfolio approaches. A portfolio approach is a business strategy consisting of a taxpayer bundling certain transactions for the purpose of earning an appropriate return across the portfolio rather than necessarily on any single product within the portfolio. For instance, some products may be marketed by a taxpayer with a low profit or even at a loss, because they create a demand for other products and/or related services of the same taxpayer that are then sold or provided with high profits (e.g. equipment and captive aftermarket consumables, such as vending coffee machines and coffee capsules, or printers and cartridges). Similar approaches can be observed in various industries. Portfolio approaches are an example of a business strategy that may need to be taken into account in the comparability analysis and when examining the reliability of comparables. See paragraphs 1.59-1.63 on business strategies. However, as discussed in paragraphs 1.70-1.72, these considerations will not explain continued overall losses or poor performance over time. Moreover, in order to be acceptable, portfolio approaches must be reasonably targeted as they should not be used to apply a transfer pricing method at the taxpayer's company-wide level in those cases where different transactions have different economic logic and should be segmented. See paragraphs 2.78-2.79. Finally, the above comments should not be misread as implying that it would be acceptable for one entity within an MNE group to have a below arm's length return in order to provide benefits to another entity of the MNE group, see in particular paragraph 1.71.

3.11 While some separately contracted transactions between associated enterprises may need to be evaluated together in order to determine whether the conditions are arm's length, other transactions contracted between such enterprises as a package may need to be evaluated separately. An MNE may package as a single transaction and establish a single price for a number of benefits such as licences for patents, know-how, and trademarks, the provision of technical and administrative services, and the lease of production facilities. This type of arrangement is often referred to as a package deal. Such comprehensive packages would be unlikely to include sales of goods, however, although the price charged for sales of goods may cover some accompanying services. In some cases, it may not be feasible to evaluate the package as a whole so that the elements of the package must be segregated. In such cases, after determining separate transfer pricing for the separate elements, the tax administration should nonetheless consider whether in total the transfer pricing for the entire package is arm's length.

3.12 Even in uncontrolled transactions, package deals may combine elements that are subject to different tax treatment under domestic law or an income tax convention. For example, royalty payments may be subject to withholding tax but lease payments may be subject to net taxation. In such circumstances, it may still be appropriate to determine the transfer pricing on a package basis, and the tax administration could then determine whether for other tax reasons it is necessary to allocate the price to the elements of the package. In making this determination, tax administrations should examine the package deal between associated enterprises in the same way that they would analyze similar deals between independent enterprises. Taxpayers should be prepared to show that the package deal reflects appropriate transfer pricing.

### *A.3.2 Intentional set-offs*

3.13 An intentional set-off is one that associated enterprises incorporate knowingly into the terms of the controlled transactions. It occurs when one associated enterprise has provided a benefit to another associated enterprise within the group that is balanced to some degree by different benefits received from that enterprise in return. These enterprises may indicate that the benefit each has received should be set off against the benefit each has provided as full or part payment for those benefits so that only the net gain or loss (if any) on the transactions needs to be considered for purposes of assessing tax liabilities. For example, an enterprise may license another enterprise to use a patent in return for the provision of know-how in another connection and indicate that the transactions result in no profit or loss to either party. Such arrangements may sometimes be encountered between independent enterprises and should be assessed in accordance with the arm's length principle in order to quantify the value of the respective benefits presented as set-offs.

3.14 Intentional set-offs may vary in size and complexity. Such set-offs may range from a simple balance of two transactions (such as a favourable selling price for manufactured goods in return for a favourable purchase price for the raw material used in producing the goods) to an arrangement for a general settlement balancing all benefits accruing to both parties over a period. Independent enterprises would be very unlikely to consider the latter type of arrangement unless the benefits could be sufficiently accurately quantified and the contract is created in advance. Otherwise, independent enterprises normally would prefer to allow their receipts and disbursements to flow independently of each other, taking any profit or loss resulting from normal trading.

3.15 Recognition of intentional set-offs does not change the fundamental requirement that for tax purposes the transfer prices for controlled transactions must be consistent with the arm's length principle. It would be a good practice for taxpayers to disclose the existence of set-offs intentionally built into two or more transactions between associated enterprises and demonstrate (or acknowledge that they have relevant supporting information and have undertaken sufficient analysis to be able to show) that, after taking account of the set-offs, the conditions governing the transactions are consistent with the arm's length principle.

3.16 It may be necessary to evaluate the transactions separately to determine whether they each satisfy the arm's length principle. If the transactions are to be analysed together, care should be taken in selecting comparable transactions and regard had to the discussion at paragraphs 3.9-3.12. The terms of set-offs relating to international transactions between associated enterprises may not be fully consistent with those relating to purely domestic transactions between independent enterprises because of the differences in tax treatment of the set-off under different national tax systems or differences in the treatment of the payment under a bilateral tax treaty. For example, withholding tax would complicate a set-off of royalties against sales receipts.

3.17 A taxpayer may seek on examination a reduction in a transfer pricing adjustment based on an unintentional over-reporting of taxable income. Tax administrations in their discretion may or may not grant this request. Tax administrations may also consider such requests in the context of mutual agreement procedures and corresponding adjustments (see Chapter IV).

### *A.3.3 Choice of the tested party*

3.18 When applying a cost plus, resale price or transactional net margin method as described in Chapter II, it is necessary to choose the party to the transaction for which a financial indicator (mark-up on costs, gross margin, or net profit indicator) is tested. The choice of the tested party should be consistent with the functional analysis of the transaction. As a general rule, the tested party is the one to which a

transfer pricing method can be applied in the most reliable manner and for which the most reliable comparables can be found, *i.e.* it will most often be the one that has the less complex functional analysis.

3.19 This can be illustrated as follows. Assume that company A manufactures two types of products, P1 and P2, that it sells to company B, an associated enterprise in another country. Assume that A is found to manufacture P1 products using valuable, unique intangibles that belong to B and following technical specifications set by B. Assume that in this P1 transaction, A only performs simple functions and does not make any valuable, unique contribution in relation to the transaction. The tested party for this P1 transaction would most often be A. Assume now that A is also manufacturing P2 products for which it owns and uses valuable unique intangibles such as valuable patents and trademarks, and for which B acts as a distributor. Assume that in this P2 transaction, B only performs simple functions and does not make any valuable, unique contribution in relation to the transaction. The tested party for the P2 transaction would most often be B.

#### *A.3.4 Information on the controlled transaction*

3.20 In order to select and apply the most appropriate transfer pricing method to the circumstances of the case, information is needed on the comparability factors in relation to the controlled transaction under review and in particular on the functions, assets and risks of all the parties to the controlled transaction, including the foreign associated enterprise(s). Specifically, while one-sided methods (*e.g.* cost plus, resale price or transactional net margin method which are discussed in detail in Chapter II) only require examining a financial indicator or profit level indicator for one of the parties to the transaction (the “tested party” as discussed in paragraphs 3.18-3.19), some information on the comparability factors of the controlled transaction and in particular on the functional analysis of the non-tested party is also needed in order to appropriately characterise the controlled transaction and select the most appropriate transfer pricing method.

3.21 Where the most appropriate transfer pricing method in the circumstances of the case, determined following the guidance at paragraphs 2.1-2.11, is a transactional profit split, financial information on all the parties to the transaction, domestic and foreign, is needed. Given the two-sided nature of this method, the application of a transactional profit split necessitates particularly detailed information on the foreign associated enterprise party to the transaction. This includes information on the five comparability factors in order to appropriately characterise the relationship between the parties and demonstrate the appropriateness of the transactional profit split method, as well as financial information (the determination of the combined profits to be split and the splitting of the profits both rely on financial information pertaining to all the parties to the transaction, including the foreign associated enterprise). Accordingly, where the most appropriate transfer pricing method in the circumstances of the case is a transactional profit split, it would be reasonable to expect that taxpayers be ready to provide tax administrations with the necessary information on the foreign associated enterprise party to the transaction, including the financial data necessary to calculate the profit split.

3.22 Where the most appropriate transfer pricing method in the circumstances of the case, determined following the guidance at paragraphs 2.1-2.11, is a one-sided method, financial information on the tested party is needed in addition to the information referred to in paragraph 3.20 – irrespective of whether the tested party is a domestic or foreign entity. So if the most appropriate method is a cost plus, resale price or transactional net margin method and the tested party is the foreign entity, sufficient information is needed to be able to reliably apply the selected method to the foreign tested party and to enable a review by the tax administration of the country of the non-tested party of the application of the method to the foreign tested party. On the other hand, once a particular one-sided method is chosen as the most appropriate method and the tested party is the domestic taxpayer, the tax administration generally has no reason to further ask for financial data of the foreign associated enterprise.

3.23 As explained above, transfer pricing analysis necessitates some information to be available about foreign associated enterprises, the nature and extent of which depends especially on the transfer pricing method used. However, as noted at paragraph 5.11, gathering such information may present a taxpayer with difficulties that it does not encounter in producing its own information. These difficulties should be taken into account in developing rules and/or procedures on documentation.

#### **A.4 Comparable uncontrolled transactions**

##### *A.4.1 In general*

3.24 A comparable uncontrolled transaction is a transaction between two independent parties that is comparable to the controlled transaction under examination. It can be either a comparable transaction between one party to the controlled transaction and an independent party (“internal comparable”) or between two independent enterprises, neither of which is a party to the controlled transaction (“external comparable”).

3.25 Comparisons of a taxpayer’s controlled transactions with other controlled transactions carried out by the same or another MNE group are irrelevant to the application of the arm’s length principle and therefore should not be used by a tax administration as the basis for a transfer pricing adjustment or by a taxpayer to support its transfer pricing policy.

3.26 The presence of minority shareholders may be one factor leading to the outcomes of a taxpayer’s controlled transactions being closer to arm’s length, but it is not determinative in and of itself. The influence of minority shareholders depends on a number of factors, including whether the minority shareholder has a participation in the capital of the parent company or in the capital of a subsidiary, and whether it has and actually exercises some influence on the pricing of intra-group transactions.

##### *A.4.2 Internal comparables*

3.27 Step 4 of the typical process described at paragraph 3.4 is a review of existing internal comparables, if any. Internal comparables may have a more direct and closer relationship to the transaction under review than external comparables. The financial analysis may be easier and more reliable as it will presumably rely on identical accounting standards and practices for the internal comparable and for the controlled transaction. In addition, access to information on internal comparables may be both more complete and less costly.

3.28 On the other hand, internal comparables are not always more reliable and it is not the case that any transaction between a taxpayer and an independent party can be regarded as a reliable comparable for controlled transactions carried on by the same taxpayer. Internal comparables where they exist must satisfy the five comparability factors in the same way as external comparables, see paragraphs 1.38-1.63. Guidance on comparability adjustments also applies to internal comparables, see paragraphs 3.47-3.54. Assume for instance that a taxpayer manufactures a particular product, sells a significant volume thereof to its foreign associated retailer and a marginal volume of the same product to an independent party. In such a case, the difference in volumes is likely to materially affect the comparability of the two transactions. If it is not possible to make a reasonably accurate adjustment to eliminate the effects of such difference, the transaction between the taxpayer and its independent customer is unlikely to be a reliable comparable.

##### *A.4.3 External comparables and sources of information*

3.29 There are various sources of information that can be used to identify potential external comparables. This sub-section discusses particular issues that arise with respect to commercial databases,

foreign comparables and information undisclosed to taxpayers. Additionally, whenever reliable internal comparables exist, it may be unnecessary to search for external ones, see paragraphs 3.27-3.28.

#### A.4.3.1 Databases

3.30 A common source of information is commercial databases, which have been developed by editors who compile accounts filed by companies with the relevant administrative bodies and present them in an electronic format suitable for searches and statistical analysis. They can be a practical and sometimes cost-effective way of identifying external comparables and may provide the most reliable source of information, depending on the facts and circumstances of the case.

3.31 A number of limitations to commercial databases are frequently identified. Because these commercial databases rely on publicly available information, they are not available in all countries, since not all countries have the same amount of publicly available information about their companies. Moreover, where they are available, they do not include the same type of information for all the companies operating in a given country because disclosure and filing requirements may differ depending on the legal form of the company and on whether or not it is listed. Care must be exercised with respect to whether and how these databases are used, given that they are compiled and presented for non-transfer pricing purposes. It is not always the case that commercial databases provide information that is detailed enough to support the chosen transfer pricing method. Not all databases include the same level of detail and can be used with similar assurance. Importantly, it is the experience in many countries that commercial databases are used to compare the results of companies rather than of transactions because third party transactional information is rarely available. See paragraph 3.37 for a discussion of the use of non-transactional third party data.

3.32 It may be unnecessary to use a commercial database if reliable information is available from other sources, *e.g.* internal comparables. Where they are used, commercial databases should be used in an objective manner and genuine attempts should be made to use the databases to identify reliable comparable information.

3.33 Use of commercial databases should not encourage quantity over quality. In practice, performing a comparability analysis using a commercial database alone may give rise to concerns about the reliability of the analysis, given the quality of the information relevant to assessing comparability that is typically obtainable from a database. To address these concerns, database searches may need to be refined with other publicly available information, depending on the facts and circumstances. Such a refinement of the database search with other sources of information is meant to promote quality over standardised approaches and is valid both for database searches made by taxpayers/practitioners and for those made by tax administrations. It should be understood in light of the discussion of the costs and compliance burden created for the taxpayer at paragraphs 3.80-3.83.

3.34 There are also proprietary databases that are developed and maintained by some advisory firms. In addition to the issues raised above for commercial databases that are more broadly commercialised, proprietary databases also raise a further concern with respect to their coverage of data if they are based on a more limited portion of the market than commercial databases. When a taxpayer has used a proprietary database to support its transfer prices, the tax administration may request access to the database to review the taxpayer's results, for obvious transparency reasons.

#### A.4.3.2 Foreign source or non-domestic comparables

3.35 Taxpayers do not always perform searches for comparables on a country-by-country basis, *e.g.* in cases where there are insufficient data available at the domestic level and/or in order to reduce compliance costs where several entities of an MNE group have comparable functional analyses. Non-domestic

comparables should not be automatically rejected just because they are not domestic. A determination of whether non-domestic comparables are reliable has to be made on a case-by-case basis and by reference to the extent to which they satisfy the five comparability factors. Whether or not one regional search for comparables can be reliably used for several subsidiaries of an MNE group operating in a given region of the world depends on the particular circumstances in which each of those subsidiaries operates. See paragraphs 1.57-1.58 on market differences and multi-country analyses. Difficulties may also arise from differing accounting standards.

#### A.4.3.3 Information undisclosed to taxpayers

3.36 Tax administrators may have information available to them from examinations of other taxpayers or from other sources of information that may not be disclosed to the taxpayer. However, it would be unfair to apply a transfer pricing method on the basis of such data unless the tax administration was able, within the limits of its domestic confidentiality requirements, to disclose such data to the taxpayer so that there would be an adequate opportunity for the taxpayer to defend its own position and to safeguard effective judicial control by the courts.

#### A.4.4 Use of non-transactional third party data

3.37 The transactional focus of transfer pricing methods and the question of a possible aggregation of the taxpayer's controlled transactions are discussed at paragraphs 3.9-3.12. A different question is whether non-transactional third party data can provide reliable comparables for a taxpayer's controlled transactions (or set of transactions aggregated consistently with the guidance at paragraphs 3.9-3.12). In practice, available third party data are often aggregated data, at a company-wide or segment level, depending on the applicable accounting standards. Whether such non-transactional third party data can provide reliable comparables for the taxpayer's controlled transaction or set of transactions aggregated consistently with the guidance at paragraphs 3.9-3.12 depends in particular on whether the third party performs a range of materially different transactions. Where segmented data are available, they can provide better comparables than company-wide, non-segmented data, because of a more transactional focus, although it is recognised that segmented data can raise issues in relation to the allocation of expenses to various segments. Similarly, company-wide third party data may provide better comparables than third party segmented data in certain circumstances, such as where the activities reflected in the comparables correspond to the set of controlled transactions of the taxpayer.

#### A.4.5 Limitations in available comparables

3.38 The identification of potential comparables has to be made with the objective of finding the most reliable data, recognising that they will not always be perfect. For instance, independent transactions may be scarce in certain markets and industries. A pragmatic solution may need to be found, on a case-by-case basis, such as broadening the search and using information on uncontrolled transactions taking place in the same industry and a comparable geographical market, but performed by third parties that may have different business strategies, business models or other slightly different economic circumstances; information on uncontrolled transactions taking place in the same industry but in other geographical markets; or information on uncontrolled transactions taking place in the same geographical market but in other industries. The choice among these various options will depend on the facts and circumstances of the case, and in particular on the significance of the expected effects of comparability defects on the reliability of the analysis.

3.39 A transactional profit split method might in appropriate circumstances be considered without comparable data, *e.g.* where the absence of comparable data is due to the presence of valuable, unique intangibles contributed by each party to the transaction (see paragraph 2.109). However, even in cases

where comparable data are scarce and imperfect, the selection of the most appropriate transfer pricing method should be consistent with the functional analysis of the parties, see paragraph 2.2.

#### **A.5 *Selecting or rejecting potential comparables***

3.40 There are basically two ways in which the identification of potentially comparable third party transactions can be conducted.

3.41 The first one, which can be qualified as the “additive” approach, consists of the person making the search drawing up a list of third parties that are believed to carry out potentially comparable transactions. Information is then collected on transactions conducted by these third parties to confirm whether they are in effect acceptable comparables, based on the pre-determined comparability criteria. This approach arguably gives well-focused results – all the transactions retained in the analysis are carried out by well-known players in the taxpayer’s market. As indicated above, in order to ensure a sufficient degree of objectivity it is important that the process followed be transparent, systematic and verifiable. The “additive” approach may be used as the sole approach where the person making the search has knowledge of a few third parties that are engaged in transactions that are comparable to the examined controlled transaction. It is worth noting that the “additive” approach presents similarities with the approach followed when identifying internal comparables. In practice, an “additive” approach may encompass both internal and external comparables.

3.42 The second possibility, the “deductive” approach, starts with a wide set of companies that operate in the same sector of activity, perform similar broad functions and do not present economic characteristics that are obviously different. The list is then refined using selection criteria and publicly available information (*e.g.* from databases, Internet sites, information on known competitors of the taxpayer). In practice, the “deductive” approach typically starts with a search on a database. It is therefore important to follow the guidance on internal comparables and on the sources of information on external comparables, see paragraphs 3.24-3.39. In addition, the “deductive” approach is not appropriate to all cases and all methods and the discussion in this section should not be interpreted as affecting the criteria for selecting a transfer pricing method set out in paragraphs 2.1-2.11.

3.43 In practice, both quantitative and qualitative criteria are used to include or reject potential comparables. Examples of qualitative criteria are found in product portfolios and business strategies. The most commonly observed quantitative criteria are:

- Size criteria in terms of Sales, Assets or Number of Employees. The size of the transaction in absolute value or in proportion to the activities of the parties might affect the relative competitive positions of the buyer and seller and therefore comparability.
- Intangible-related criteria such as ratio of Net Value of Intangibles/Total Net Assets Value, or ratio of Research and Development (“R&D”)/Sales where available: they may be used for instance to exclude companies with valuable intangibles or significant R&D activities when the tested party does not use valuable intangible assets nor participate in significant R&D activities.
- Criteria related to the importance of export sales (Foreign Sales/Total Sales), where relevant.
- Criteria related to inventories in absolute or relative value, where relevant.

- Other criteria to exclude third parties that are in particular special situations such as start-up companies, bankrupted companies, etc. when such peculiar situations are obviously not appropriate comparisons.

The choice and application of selection criteria depends on the facts and circumstances of each particular case and the above list is neither limitative nor prescriptive.

3.44 One advantage of the “deductive” approach is that it is more reproducible and transparent than the “additive”. It is also easier to verify because the review concentrates on the process and on the relevance of the selection criteria retained. On the other hand, it is acknowledged that the quality of the outcome of a “deductive” approach depends on the quality of the search tools on which it relies (*e.g.* quality of the database where a database is used and possibility to obtain detailed enough information). This can be a practical limitation in some countries where the reliability and usefulness of databases in comparability analyses are questionable.

3.45 It would not be appropriate to give systematic preference to one approach over the other because, depending on the circumstances of the case, there could be value in either the “additive” or the “deductive” approach, or in a combination of both. The “additive” and “deductive” approaches are often not used exclusively. In a typical “deductive” approach, in addition to searching public databases it is common to include third parties, for instance known competitors (or third parties that are known to carry out transactions potentially comparable to those of the taxpayer), which may otherwise not be found following a purely deductive approach, *e.g.* because they are classified under a different industry code. In such cases, the “additive” approach operates as a tool to refine a search that is based on a “deductive” approach.

3.46 The process followed to identify potential comparables is one of the most critical aspects of the comparability analysis and it should be transparent, systematic and verifiable. In particular, the choice of selection criteria has a significant influence on the outcome of the analysis and should reflect the most meaningful economic characteristics of the transactions compared. Complete elimination of subjective judgments from the selection of comparables would not be feasible, but much can be done to increase objectivity and ensure transparency in the application of subjective judgments. Ensuring transparency of the process may depend on the extent to which the criteria used to select potential comparables are able to be disclosed and the reasons for excluding some of the potential comparables are able to be explained. Increasing objectivity and ensuring transparency of the process may also depend on the extent to which the person reviewing the process (whether taxpayer or tax administration) has access to information regarding the process followed and to the same sources of data. Issues of documentation of the process of identifying comparables are discussed in Chapter V.

## **A.6 Comparability adjustments**

3.47 The need to adjust comparables and the requirement for accuracy and reliability are pointed out in these Guidelines on several occasions, both for the general application of the arm’s length principle and more specifically in the context of each method. As noted at paragraph 1.33, to be comparable means that none of the differences (if any) between the situations being compared could materially affect the condition being examined in the methodology or that reasonably accurate adjustments can be made to eliminate the effect of any such differences. Whether comparability adjustments should be performed (and if so, what adjustments should be performed) in a particular case is a matter of judgment that should be evaluated in light of the discussion of costs and compliance burden at Section C.

#### *A.6.1 Different types of comparability adjustments*

3.48 Examples of comparability adjustments include adjustments for accounting consistency designed to eliminate differences that may arise from differing accounting practices between the controlled and uncontrolled transactions; segmentation of financial data to eliminate significant non-comparable transactions; adjustments for differences in capital, functions, assets, risks.

3.49 An example of a working capital adjustment designed to reflect differing levels of accounts receivable, accounts payable and inventory is provided in the Annex to Chapter III. The fact that such adjustments are found in practice does not mean that they should be performed on a routine or mandatory basis. Rather, the improvement to comparability should be shown when proposing these types of adjustments (as for any type of adjustment). Further, a significantly different level of relative working capital between the controlled and uncontrolled parties may result in further investigation of the comparability characteristics of the potential comparable.

#### *A.6.2 Purpose of comparability adjustments*

3.50 Comparability adjustments should be considered if (and only if) they are expected to increase the reliability of the results. Relevant considerations in this regard include the materiality of the difference for which an adjustment is being considered, the quality of the data subject to adjustment, the purpose of the adjustment and the reliability of the approach used to make the adjustment.

3.51 It bears emphasis that comparability adjustments are only appropriate for differences that will have a material effect on the comparison. Some differences will invariably exist between the taxpayer's controlled transactions and the third party comparables. A comparison may be appropriate despite an unadjusted difference, provided that the difference does not have a material effect on the reliability of the comparison. On the other hand, the need to perform numerous or substantial adjustments to key comparability factors may indicate that the third party transactions are in fact not sufficiently comparable.

3.52 It is not always the case that adjustments are warranted. For instance, an adjustment for differences in accounts receivable may not be particularly useful if major differences in accounting standards were also present that could not be resolved. Likewise, sophisticated adjustments are sometimes applied to create the false impression that the outcome of the comparables search is "scientific", reliable and accurate.

#### *A.6.3 Reliability of the adjustment performed*

3.53 It is not appropriate to view some comparability adjustments, such as for differences in levels of working capital, as "routine" and uncontroversial, and to view certain other adjustments, such as for country risk, as more subjective and therefore subject to additional requirements of proof and reliability. The only adjustments that should be made are those that are expected to improve comparability.

#### *A.6.4 Documenting and testing comparability adjustments*

3.54 Ensuring the needed level of transparency of comparability adjustments may depend upon the availability of an explanation of any adjustments performed, the reasons for the adjustments being considered appropriate, how they were calculated, how they changed the results for each comparable and how the adjustment improves comparability. Issues regarding documentation of comparability adjustments are discussed in Chapter V.

## A.7 *Arm's length range*

### A.7.1 *In general*

3.55 In some cases it will be possible to apply the arm's length principle to arrive at a single figure (*e.g.* price or margin) that is the most reliable to establish whether the conditions of a transaction are arm's length. However, because transfer pricing is not an exact science, there will also be many occasions when the application of the most appropriate method or methods produces a range of figures all of which are relatively equally reliable. In these cases, differences in the figures that comprise the range may be caused by the fact that in general the application of the arm's length principle only produces an approximation of conditions that would have been established between independent enterprises. It is also possible that the different points in a range represent the fact that independent enterprises engaged in comparable transactions under comparable circumstances may not establish exactly the same price for the transaction.

3.56 In some cases, not all comparable transactions examined will have a relatively equal degree of comparability. Where it is possible to determine that some uncontrolled transactions have a lesser degree of comparability than others, they should be eliminated.

3.57 It may also be the case that, while every effort has been made to exclude points that have a lesser degree of comparability, what is arrived at is a range of figures for which it is considered, given the process used for selecting comparables and limitations in information available on comparables, that some comparability defects remain that cannot be identified and/or quantified, and are therefore not adjusted. In such cases, if the range includes a sizeable number of observations, statistical tools that take account of central tendency to narrow the range (*e.g.* the interquartile range or other percentiles) might help to enhance the reliability of the analysis.

3.58 A range of figures may also result when more than one method is applied to evaluate a controlled transaction. For example, two methods that attain similar degrees of comparability may be used to evaluate the arm's length character of a controlled transaction. Each method may produce an outcome or a range of outcomes that differs from the other because of differences in the nature of the methods and the data, relevant to the application of a particular method, used. Nevertheless, each separate range potentially could be used to define an acceptable range of arm's length figures. Data from these ranges could be useful for purposes of more accurately defining the arm's length range, for example when the ranges overlap, or for reconsidering the accuracy of the methods used when the ranges do not overlap. No general rule may be stated with respect to the use of ranges derived from the application of multiple methods because the conclusions to be drawn from their use will depend on the relative reliability of the methods employed to determine the ranges and the quality of the information used in applying the different methods.

3.59 Where the application of the most appropriate method (or, in relevant circumstances, of more than one method, see paragraph 2.11), produces a range of figures, a substantial deviation among points in that range may indicate that the data used in establishing some of the points may not be as reliable as the data used to establish the other points in the range or that the deviation may result from features of the comparable data that require adjustments. In such cases, further analysis of those points may be necessary to evaluate their suitability for inclusion in any arm's length range.

### A.7.2 *Selecting the most appropriate point in the range*

3.60 If the relevant condition of the controlled transaction (*e.g.* price or margin) is within the arm's length range, no adjustment should be made.

3.61 If the relevant condition of the controlled transaction (*e.g.* price or margin) falls outside the arm's length range asserted by the tax administration, the taxpayer should have the opportunity to present

arguments that the conditions of the controlled transaction satisfy the arm's length principle, and that the result falls within the arm's length range (*i.e.* that the arm's length range is different from the one asserted by the tax administration). If the taxpayer is unable to establish this fact, the tax administration must determine the point within the arm's length range to which it will adjust the condition of the controlled transaction.

3.62 In determining this point, where the range comprises results of relatively equal and high reliability, it could be argued that any point in the range satisfies the arm's length principle. Where comparability defects remain as discussed at paragraph 3.57, it may be appropriate to use measures of central tendency to determine this point (for instance the median, the mean or weighted averages, etc., depending on the specific characteristics of the data set), in order to minimise the risk of error due to unknown or unquantifiable remaining comparability defects.

#### *A.7.3 Extreme results: comparability considerations*

3.63 Extreme results might consist of losses or unusually high profits. Extreme results can affect the financial indicators that are looked at in the chosen method (*e.g.* the gross margin when applying a resale price, or a net profit indicator when applying a transactional net margin method). They can also affect other items, *e.g.* exceptional items which are below the line but nonetheless may reflect exceptional circumstances. Where one or more of the potential comparables have extreme results, further examination would be needed to understand the reasons for such extreme results. The reason might be a defect in comparability, or exceptional conditions met by an otherwise comparable third party. An extreme result may be excluded on the basis that a previously overlooked significant comparability defect has been brought to light, not on the sole basis that the results arising from the proposed "comparable" merely appear to be very different from the results observed in other proposed "comparables".

3.64 An independent enterprise would not continue loss-generating activities unless it had reasonable expectations of future profits. See paragraphs 1.70 to 1.72. Simple or low risk functions in particular are not expected to generate losses for a long period of time. This does not mean however that loss-making transactions can never be comparable. In general, all relevant information should be used and there should not be any overriding rule on the inclusion or exclusion of loss-making comparables. Indeed, it is the facts and circumstances surrounding the company in question that should determine its status as a comparable, not its financial result.

3.65 Generally speaking, a loss-making uncontrolled transaction should trigger further investigation in order to establish whether or not it can be a comparable. Circumstances in which loss-making transactions/enterprises should be excluded from the list of comparables include cases where losses do not reflect normal business conditions, and where the losses incurred by third parties reflect a level of risks that is not comparable to the one assumed by the taxpayer in its controlled transactions. Loss-making comparables that satisfy the comparability analysis should not however be rejected on the sole basis that they suffer losses.

3.66 A similar investigation should be undertaken for potential comparables returning abnormally large profits relative to other potential comparables.

## **B. Timing issues in comparability**

3.67 There are timing issues in comparability with respect to the time of origin, collection and production of information on comparability factors and comparable uncontrolled transactions that are used in a comparability analysis. See paragraphs 5.3, 5.4, 5.5, 5.9 and 5.14 of Chapter V for indications with respect to timing issues in the context of transfer pricing documentation requirements.

### **B.1 Timing of origin**

3.68 In principle, information relating to the conditions of comparable uncontrolled transactions undertaken or carried out during the same period of time as the controlled transaction (“contemporaneous uncontrolled transactions”) is expected to be the most reliable information to use in a comparability analysis, because it reflects how independent parties have behaved in an economic environment that is the same as the economic environment of the taxpayer’s controlled transaction. Availability of information on contemporaneous uncontrolled transactions may however be limited in practice, depending on the timing of collection.

### **B.2 Timing of collection**

3.69 In some cases, taxpayers establish transfer pricing documentation to demonstrate that they have made reasonable efforts to comply with the arm’s length principle at the time their intra-group transactions were undertaken, *i.e.* on an *ex ante* basis (hereinafter “the arm’s length price-setting” approach), based on information that was reasonably available to them at that point. Such information includes not only information on comparable transactions from previous years, but also information on economic and market changes that may have occurred between those previous years and the year of the controlled transaction. In effect, independent parties in comparable circumstances would not base their pricing decision on historical data alone.

3.70 In other instances, taxpayers might test the actual outcome of their controlled transactions to demonstrate that the conditions of these transactions were consistent with the arm’s length principle, *i.e.* on an *ex post* basis (hereinafter “the arm’s length outcome-testing” approach). Such test typically takes place as part of the process for establishing the tax return at year-end.

3.71 Both the arm’s length price-setting and the arm’s length outcome-testing approaches, as well as combinations of these two approaches, are found among OECD member countries. The issue of double taxation may arise where a controlled transaction takes place between two associated enterprises where different approaches have been applied and lead to different outcomes, for instance because of a discrepancy between market expectations taken into account in the arm’s length price-setting approach and actual outcomes observed in the arm’s length outcome-testing approach. See paragraphs 4.38 and 4.39. Competent authorities are encouraged to use their best efforts to resolve any double taxation issues that may arise from different country approaches to year-end adjustments and that may be submitted to them under a mutual agreement procedure (Article 25 of the OECD Model Tax Convention).

### **B.3 Valuation highly uncertain at the outset and unpredictable events**

3.72 The question arises whether and if so 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, in particular where valuation at that time was highly uncertain. The question should be resolved, both by taxpayers and tax administrations, by reference to what independent enterprises would have done in comparable circumstances to take account of the valuation uncertainty in the pricing of the transaction.

3.73 The reasoning that is found at paragraphs 6.28-6.32 and in Annex to Chapter VI “Examples to illustrate the Transfer Pricing Guidelines on intangible property and highly uncertain valuation” for transactions involving intangibles for which valuation is uncertain applies by analogy to other types of transactions with valuation uncertainties. The main question is to determine whether the valuation was sufficiently uncertain at the outset that the parties at arm’s length would have required a price adjustment mechanism, or whether the change in value was so fundamental a development that it would have led to a renegotiation of the transaction. Where this is the case, the tax administration would be justified in

determining the arm's length price for the transaction on the basis of the adjustment clause or renegotiation that would be provided at arm's length in a comparable uncontrolled transaction. In other circumstances, where there is no reason to consider that the valuation was sufficiently uncertain at the outset that the parties would have required a price adjustment clause or would have renegotiated the terms of the agreement, there is no reason for tax administrations to make such an adjustment as it would represent an inappropriate use of hindsight. The mere existence of uncertainty should not require an *ex post* adjustment without a consideration of what independent enterprises would have done or agreed between them.

#### ***B.4 Data from years following the year of the transaction***

3.74 Data from years following the year of the transaction may also be relevant to the analysis of transfer prices, but care must be taken to avoid the use of hindsight. For example, data from later years may be useful in comparing product life cycles of controlled and uncontrolled transactions for the purpose of determining whether the uncontrolled transaction is an appropriate comparable to use in applying a particular method. Subsequent conduct by the parties will also be relevant in ascertaining the actual terms and conditions that operate between the parties.

#### ***B.5 Multiple year data***

3.75 In practice, examining multiple year data is often useful in a comparability analysis, but it is not a systematic requirement. Multiple year data should be used where they add value to the transfer pricing analysis. It would not be appropriate to set prescriptive guidance as to the number of years to be covered by multiple year analyses.

3.76 In order to obtain a complete understanding of the facts and circumstances surrounding the controlled transaction, it generally might be useful to examine data from both the year under examination and prior years. The analysis of such information might disclose facts that may have influenced (or should have influenced) the determination of the transfer price. For example, the use of data from past years will show whether a taxpayer's reported loss on a transaction is part of a history of losses on similar transactions, the result of particular economic conditions in a prior year that increased costs in the subsequent year, or a reflection of the fact that a product is at the end of its life cycle. Such an analysis may be particularly useful where a transactional profit method is applied. See paragraph 1.72 on the usefulness of multiple year data in examining loss situations. Multiple year data can also improve the understanding of long term arrangements.

3.77 Multiple year data will also be useful in providing information about the relevant business and product life cycles of the comparables. Differences in business or product life cycles may have a material effect on transfer pricing conditions that needs to be assessed in determining comparability. The data from earlier years may show whether the independent enterprise engaged in a comparable transaction was affected by comparable economic conditions in a comparable manner, or whether different conditions in an earlier year materially affected its price or profit so that it should not be used as a comparable.

3.78 Multiple year data can also improve the process of selecting third party comparables *e.g.* by identifying results that may indicate a significant variance from the underlying comparability characteristics of the controlled transaction being reviewed, in some cases leading to the rejection of the comparable, or to detect anomalies in third party information.

3.79 The use of multiple year data does not necessarily imply the use of multiple year averages. Multiple year data and averages can however be used in some circumstances to improve reliability of the range. See paragraphs 3.57-3.62 for a discussion of statistical tools.

## **C. Compliance issues**

3.80 One question that arises when putting the need for comparability analyses into perspective is the extent of the burden and costs that should be borne by a taxpayer to identify possible comparables and obtain detailed information thereon. It is recognised that the cost of information can be a real concern, especially for small to medium sized operations, but also for those MNEs that deal with a very large number of controlled transactions in many countries. Paragraphs 4.28, 5.6, 5.7 and 5.28 contain explicit recognition of the need for a reasonable application of the requirement to document comparability.

3.81 When undertaking a comparability analysis, there is no requirement for an exhaustive search of all possible relevant sources of information. Taxpayers and tax administrations should exercise judgment to determine whether particular comparables are reliable.

3.82 It is a good practice for taxpayers to set up a process to establish, monitor and review their transfer prices, taking into account the size of the transactions, their complexity, level of risk involved, and whether they are performed in a stable or changing environment. Such a practical approach would conform to a pragmatic risk assessment strategy or prudent business management principle. In practice, this means that it may be reasonable for a taxpayer to devote relatively less effort to finding information on comparables supporting less significant or less material controlled transactions. For simple transactions that are carried out in a stable environment and the characteristics of which remain the same or similar, a detailed comparability (including functional) analysis may not be needed every year.

3.83 Small to medium sized enterprises are entering into the area of transfer pricing and the number of cross-border transactions is ever increasing. Although the arm's length principle applies equally to small and medium sized enterprises and transactions, pragmatic solutions may be appropriate in order to make it possible to find a reasonable response to each transfer pricing case.

*Annex I to Chapter II*

**Sensitivity of Gross and Net Profit Indicators**

See Chapter II, Part III, Section B of these Guidelines for general guidance on the application of the transactional net margin method.

The assumptions about arm's length arrangements in the following examples are intended for illustrative purposes only and should not be taken as prescribing adjustments and arm's length arrangements in actual cases of particular industries. While they seek to demonstrate the principles of the sections of the Guidelines to which they refer, those principles must be applied in each case according to the specific facts and circumstances of that case.

Furthermore, the comments below relate to the application of a transactional net margin method in the situations where, given the facts and circumstances of the case and in particular the comparability (including functional) analysis of the transaction and the review of the information available on uncontrolled comparables, such a method is found to be the most appropriate method to be used.

1. It is recognised that the transactional net margin method can be less sensitive to some differences in the characteristics of products than the comparable uncontrolled price or resale price methods. In practice when applying the transactional net margin method a greater emphasis is generally placed on functional comparability than on the characteristics of products. The transactional net margin method can however be less sensitive to some differences in functions which are reflected in variations in operating expenses as illustrated below.

**Illustration 1:**  
**Effect of a difference in the extent and complexity of the marketing function performed by a distributor**

*The example below is for illustration only. It is not intended to provide any guidance on the selection of the transfer pricing method or of comparables, on the efficiency of distributors or on arm's length rates of return, but only to illustrate the effects of differences between the extent and complexity of the marketing function of a distributor and of comparables.*

	<b>Case 1</b> <b>The distributor performs a limited marketing function</b>	<b>Case 2</b> <b>The distributor performs a more significant marketing function</b>
<b>Sales of product</b> (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
<b>Purchase price from manufacturer taking account of the significance of the marketing function in accordance to the functional analysis</b>	600	480 (*)
<b>Gross margin</b>	400 (40%)	520 (52%)
<b>Marketing expenses</b>	50	150
<b>Other expenses (overheads)</b>	300	300
<b>Net profit margin</b>	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)

2. Under Illustration 1, if a taxpayer is operating with an associated manufacturer as in case 2 while the third party “comparables” are operating as in case 1, and assuming that the difference in the extent and complexity of the marketing function is not identified because of for instance insufficiently detailed information on the third party “comparables”, then the risk of error when applying a gross margin method could amount to 120 (12% x 1,000), while it would amount to 20 (2% x 1,000) if a net margin method was applied. This illustrates the fact that, depending on the circumstances of the case and in particular of the effect of the functional differences on the cost structure and on the revenue of the “comparables”, net profit margins can be less sensitive than gross margins to differences in the extent and complexity of functions.

### **Illustration 2:**

#### **Effect of a difference in the level of risk assumed by a distributor**

The example below is for illustration only. It is not intended to provide any guidance on the selection of the transfer pricing method or of comparables, on the efficiency of distributors or on arm's length rates of return, but only to illustrate the effects of differences between the level of risk assumed by a distributor and by comparables.

	<b>Case 1</b> 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 by the manufacturer.	<b>Case 2</b> The distributor assumes the risk of obsolescence of products. It does not benefit from a “buy-back” clause in its contractual relationship with the manufacturer.
<b>Sales of product</b> (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
<b>Purchase price from manufacturer taking account of the obsolescence risk in accordance with the functional analysis</b>	700	640 (*)
<b>Gross margin</b>	300 (30%)	360 (36%)
<b>Loss on obsolete inventory</b>	0	50
<b>Other expenses (overheads)</b>	250	250
<b>Net profit margin</b>	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.

3. Under Illustration 2, if a controlled transaction is performed as in case 1 while the third party “comparables” are operating as in case 2, and assuming that the difference in the level of risks is not identified due to insufficiently detailed information on the third party “comparables”, then the risk of error when applying a gross margin method could amount to 60 (6% x 1,000) instead of 10 (1% x 1,000) if a net margin method is applied. This illustrates the fact that, depending on the circumstances of the case and in particular of the effect of the differences in the level of risks on the cost structure and on the revenue of the “comparables”, net profit margins can be less sensitive than gross margins to differences in the level of risks (assuming the contractual allocation of risks is arm's length).

4. Consequently, enterprises performing different functions may have a wide range of gross profit margins while still earning broadly similar levels of net profits. For instance, business commentators note that the transactional net margin method would be less sensitive to differences in volume, extent and complexity of functions and operating expenses. On the other hand, the transactional net margin method may be more sensitive than the cost plus or resale price methods to differences in capacity utilisation, because differences in the levels of absorption of indirect fixed costs (*e.g.* fixed manufacturing costs or fixed distribution costs) would affect the net profit but may not affect the gross margin or gross mark-up on costs if not reflected in price differences, as illustrated below.

**Illustration 3:**

***Effect of a difference in manufacturers' capacity utilisation***

*The example below is for illustration only and is not intended to provide any guidance on the selection of the transfer pricing method or of comparables, or on arm's length rates of return, but only to illustrate the effects of differences between the capacity utilisation of a manufacturer and of comparables.*

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>i.e.</i> only manufactures 80% of what it could manufacture in full capacity: 800 units per year
<b>Sales of manufactured products</b> (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 1 m.u. per manufactured product) (*).	1,000	800
<b>Cost of goods sold: direct costs plus standard allocation of indirect manufacturing costs.</b> (for illustration purposes, assume both manufacturers have the same variable cost of goods sold per manufactured unit, <i>i.e.</i> 0.75 m.u. per manufactured product, and fixed personnel costs of 50).	Variable: 750 Fixed: 50 Total: 800	Variable: 600 Fixed: 50 Total: 650
<b>Gross mark-up on cost of goods sold</b>	200 (25%)	150 (23%)
<b>Indirect costs</b> (for illustration purposes, assume both manufacturers have the same indirect costs)	150	150
<b>Net profit margin</b>	50 (5%)	Breakeven

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

5. Under Illustration 3, if a controlled transaction is performed as in case 1 while the third party "comparables" are operating as in case 2, and assuming that the difference in the capacity utilisation is not identified due to insufficiently detailed information on the third party "comparables", then the risk of error when applying a gross margin method could amount to 16 (2% x 800) instead of 50 (5% x 1000) if a net margin method is applied. This illustrates the fact that net profit indicators can be more sensitive than gross mark-ups or gross margins to differences in the capacity utilisation, depending on the facts and circumstances of the case and in particular on the proportion of fixed and variable costs and on whether it is the taxpayer or the "comparable" which is in an over-capacity situation.

*Annex III to Chapter II*

**Illustration of Different Measures of Profits When Applying a Transactional Profit Split Method**

See Chapter II, Part III, Section C of these Guidelines for general guidance on the application of the transactional profit split method.

The assumptions about arm's length arrangements in the following examples are intended for illustrative purposes only and should not be taken as prescribing adjustments and arm's length arrangements in actual cases of particular industries. While they seek to demonstrate the principles of the sections of the Guidelines to which they refer, those principles must be applied in each case according to the specific facts and circumstances of that case.

Furthermore, the comments below relate to the application of a transactional profit split method in the situations where, given the facts and circumstances of the case and in particular the comparability (including functional) analysis of the transaction and the review of the information available on uncontrolled comparables, such a method is found to be the most appropriate method to be used.

1. Below are some illustrations of the effect of choosing a measure of profits to determine the combined profits to be split when applying a transactional profit split method.
2. Assume A and B are two associated enterprises situated in two different tax jurisdictions. Both manufacture the same widgets and incur expenditure that results in the creation of an intangible asset which they can mutually use. For the purpose of this example, it is assumed that the nature of this particular asset is such that the value of the asset contribution attributable to each of A and B in the year in question is proportional to A and B's relative expenditure on the asset in that year. (It should be noted that this assumption will not always be true in practice. This is because there may be cases where the relative values of asset contributions attributable to each party would be based on accumulated expenditure from the prior, as well as current years.) Assume A and B exclusively sell products to third parties. Assume that it is determined that the most appropriate method to be used is a residual profit split method, that the manufacturing activities of A and B are simple, non-unique transactions that should be allocated an initial return of 10% of the Cost of Goods Sold and that the residual profit should be split in proportion to A's and B's intangible asset expenditure. The following figures are for illustration only:

	<b>A</b>	<b>B</b>	<b>Combined A + B</b>
<b>Sales</b>	100	300	400
<b>Cost Of Goods Sold</b>	60	170	230
<b>Gross Profit</b>	40	130	170
<b>Overhead expenses</b>	3	6	9
<b>Other operating expenses</b>	2	4	6
<b>Intangible asset expenditure</b>	30	40	70
<b>Operating Profit</b>	5	80	85

3. *Step one: determining the initial return for the non-unique manufacturing transactions (Cost of Goods Sold + 10% in this example)*

<b>A</b>	$60 + (60 * 10\%) = 66$	→ Initial return for the manufacturing transactions of A =	6
<b>B</b>	$170 + (170 * 10\%) = 187$	→ Initial return for the manufacturing transactions of B =	17
Total profit allocated through initial returns (6+17) =			23

4. *Step two: determining the residual profit to be split*

a) *In case it is determined as the operating profit:*

<b>Combined Operating Profit</b>	85
<b>Profit already allocated (initial returns for manufacturing transactions)</b>	23
<b>Residual profit to be split in proportion to A's and B's intangible asset expenditure</b>	62

<b>Residual profit allocated to A:</b>	$62 * 30/70$	26.57
<b>Residual profit allocated to B:</b>	$62 * 40/70$	35.43

<b>Total profits allocated to A:</b>	6 (initial return) + 26.57 (residual)	32.57
<b>Total profits allocated to B:</b>	17 (initial return) + 35.43 (residual)	52.43
<b>Total</b>		85

b) *In case it is determined as the operating profit before overhead expenses (assuming it is determined that the overhead expenses of A and B do not relate to the transaction examined and should be excluded from the determination of the combined profits to be split):*

	<b>A</b>	<b>B</b>	<b>Combined A + B</b>
<b>Sales</b>	100	300	400
<b>Cost Of Goods Sold</b>	60	170	230
<b>Gross Profit</b>	40	130	170
<b>Other operating expenses</b>	2	4	6
<b>Intangible asset expenditure</b>	30	40	70
<b>Operating Profit before overhead expenses</b>	8	86	94
<b>Overhead expenses</b>	3	6	9
<b>Operating Profit</b>	5	80	85

<b>Combined Operating Profit before overhead expenses</b>	94
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<b>Profit already allocated (initial returns for manufacturing transactions)</b>	23
<b>Residual profit before overhead expenses to be split in proportion to A's and B's intangible asset expenditure</b>	71

<b>Residual profit allocated to A:</b>	$71 * 30/70$	30.43
<b>Residual profit allocated to B:</b>	$71 * 40/70$	40.57

<b>Total profits allocated to A:</b>	6 (initial return) + 30.43 (residual) – 3 (overhead expenses)	33.43
<b>Total profits allocated to B:</b>	17 (initial return) + 40.57 (residual) – 6 (overhead expenses)	51.57
<b>Total</b>		85

5. As shown in the above example, excluding some specific items from the determination of the combined profits to be split implies that each party remains responsible for its own expenses in relation to it. As a consequence, the decision whether or not to exclude some specific items must be consistent with the comparability (including functional) analysis of the transaction.

6. As another example, in some cases it may be appropriate to back out a category of expenses to the extent that the allocation key used in the residual profit split analysis relies on those expenses. For example, in cases where relative expenditure contributing to the development of an intangible asset is determined to be the most appropriate profit split factor, residual profits can be based on operating profits *before* that expenditure. After determining the split of residual profits, each associated enterprise then subtracts its own expenditure. This can be illustrated as follows. Assume the facts are the same as in the example at paragraph 2 above and assume the overhead expenses are not excluded from the determination of the residual profit to be split.

7. *Step one: determining the basic return for the manufacturing activities (Cost of Goods Sold + 10% in this example)*

Same as at paragraph 3.

8. *Step two: determining the residual profit to be split*

a) *In case it is determined as the operating profit after intangible asset expenditure:*

Same as at paragraph 4, case a)

b) *In case it is determined as the operating profit before intangible asset expenditure:*

	<b>A</b>	<b>B</b>	<b>Combined A + B</b>
<b>Sales</b>	100	300	400
<b>Cost Of Goods Sold</b>	60	170	230

<b>Gross Profit</b>	40	130	170
<b>Overhead expenses</b>	3	6	9
<b>Other operating expenses</b>	2	4	6
<b>Operating profit intangible asset expenditure</b>	35	120	155
<b>Intangible asset expenditure</b>	30	40	70
<b>Operating Profit</b>	5	80	85

<b>Combined Operating Profit before intangible asset expenditure</b>	155
<b>Profit already allocated (initial returns for manufacturing transactions)</b>	23
<b>Residual profit before intangible asset expenditure to be split in proportion to A's and B's intangible asset expenditure</b>	132

<b>Residual profit allocated to A:</b>	$132 * 30/70$	56.57
<b>Residual profit allocated to B:</b>	$132 * 40/70$	75.43

<b>Total profits allocated to A:</b>	6 (initial return) + 56.57 (residual) – 30 (intangible asset expenditure)	32.57
<b>Total profits allocated to B:</b>	17 (initial return) + 75.43 (residual) – 40 (intangible asset expenditure)	52.43
<b>Total</b>		85

*i.e.* A and B are allocated the same profits as in the case where the profit to be split is determined as the operating profit after intangible asset expenditure, see case a) above.

9. This example illustrates the fact that, when the allocation key used to split the residual profit relies on a category of expenses incurred during the period, it is indifferent whether the residual profit to be split is determined before said expenses and the expenses are deducted by each party, or whether the residual profit to be split is determined after said expenses. The outcome can however be different in the case where the split factor is based on the accumulated expenditure of the prior as well as current years (see paragraph 2 above).

### **Example of a Working Capital Adjustment**

See Chapter III, Section A.6 of these Guidelines for general guidance on comparability adjustments.

The assumptions about arm's length arrangements in the following examples are intended for illustrative purposes only and should not be taken as prescribing adjustments and arm's length arrangements in actual cases of particular industries. While they seek to demonstrate the principles of the sections of the Guidelines to which they refer, those principles must be applied in each case according to the specific facts and circumstances of that case.

This example is provided for illustration purposes as it represents one way, but not necessarily the only way, in which such an adjustment can be calculated.

Furthermore, the comments below relate to the application of a transactional net margin method in the situations where, given the facts and circumstances of the case and in particular the comparability (including functional) analysis of the transaction and the review of the information available on uncontrolled comparables, such a method is found to be the most appropriate method to be used.

#### **Introduction**

1. This simple example shows how to make an adjustment in recognition of differences in levels of working capital between a tested party (TestCo) and a comparable (CompCo). See paragraphs 3.47-3.54 of these Guidelines for general guidance on comparability adjustments. Working capital adjustments may be warranted when applying the transactional net margin method. In practice they are usually found when applying a transactional net margin method, although they might also be applicable in cost plus or resale price methods. Working capital adjustments should only be considered when the reliability of the comparables will be improved and reasonably accurate adjustments can be made. They should not be automatically made and would not be automatically accepted by tax administrations.

#### **Why make a working capital adjustment?**

2. In a competitive environment, money has a time value. If a company provided, say, 60 days trade terms for payment of accounts, the price of the goods should equate to the price for immediate payment plus 60 days of interest on the immediate payment price. By carrying high accounts receivable a company is allowing its customers a relatively long period to pay their accounts. It would need to borrow money to fund the credit terms and/or suffer a reduction in the amount of cash surplus which it would otherwise have available to invest. In a competitive environment, the price should therefore include an element to reflect these payment terms and compensate for the timing effect.

3. The opposite applies to higher levels of accounts payable. By carrying high accounts payable, a company is benefitting from a relatively long period to pay its suppliers. It would need to borrow less money to fund its purchases and/or benefit from an increase in the amount of cash surplus available to invest. In a competitive environment, the cost of goods sold should include an element to reflect these payment terms and compensate for the timing effect.

4. A company with high levels of inventory would similarly need to either borrow to fund the purchase or reduce the amount of cash surplus which the company is able to invest. Note that the interest rate might be affected by the funding structure (*e.g.* where the purchase of inventory is partly funded by equity) or by the risk associated with holding specific types of inventory.

5. Making a working capital adjustment is an attempt to adjust for the differences in time value of money between the tested party and potential comparables with an assumption that the difference should be reflected in profits. The underlying reasoning is that:

- A company will need funding to cover the time gap between the time it invests money (*i.e.* pays money to supplier) and the time it collects the investment (*i.e.* collects money from customers)
- This time gap is calculated as: the period needed to sell inventories to customers + (plus) the period needed to collect money from customers – (less) the period granted to pay debts to suppliers.

**6. The process of calculating working capital adjustments:**

- a) Identify differences in the levels of working capital. Generally trade receivables, inventory and trade payables are the three accounts considered. The transactional net margin method is applied relative to an appropriate base, for example costs, sales or assets (see paragraph 2.58 of the Guidelines). If the appropriate base is sales, for example, then any differences in working capital levels should be measured relative to sales.
- b) Calculate a value for differences in levels of working capital between the tested party and the comparable relative to the appropriate base and reflecting the time value of money by use of an appropriate interest rate.
- c) Adjust the result to reflect differences in levels of working capital. The following example adjusts the comparable's result to reflect the tested party's levels of working capital. Alternative calculations are to adjust the tested party's results to reflect the comparables levels of working capital or to adjust both the tested party and the comparable's results to reflect "zero" working capital.

**A practical example of calculating working capital adjustments:**

7. The following calculation is hypothetical. It is only to demonstrate how a working capital adjustment can be calculated.

TestCo	Year 1	Year 2	Year 3	Year 4	Year 5
Sales	\$179.5m	\$182.5m	\$187m	\$195m	\$198m
Earnings Before Interest & Tax (EBIT)	\$1.5m	\$1.83m	\$2.43m	\$2.54m	\$1.78m
EBIT/Sales (%)	0.8%	1%	1.3%	1.3%	0.9%
<b>Working Capital (at end of year)<sup>1</sup></b>					
Trade Receivables (R)	\$30m	\$32m	\$33m	\$35m	\$37m
Inventories (I)	\$36m	\$36m	\$38m	\$40m	\$45m
Trade Payables (P)	\$20m	\$21m	\$26m	\$23m	\$24m
Receivables (R) + Inventory (I) – Payables (P)	\$46m	\$47m	\$45m	\$52m	\$58m
(R + I – P) / Sales	25.6%	25.8%	24.1%	26.7%	29.3%

CompCo	Year 1	Year 2	Year 3	Year 4	Year 5
Sales	\$120.4m	\$121.2m	\$121.8m	\$126.3m	\$130.2m
Earnings Before Interest & Tax (EBIT)	\$1.59m	\$3.59m	\$3.15m	\$4.18m	\$6.44m
EBIT/Sales (%)	1.32%	2.96%	2.59%	3.31%	4.95%
<b>Working Capital (at end of year)<sup>1</sup></b>					
Trade Receivables (R)	\$17m	\$18m	\$20m	\$22m	\$23m
Inventory (I)	\$18m	\$20m	\$26m	\$24m	\$25m
Trade Payables (P)	\$11m	\$13m	\$11m	\$15m	\$16m
Receivables (R) + Inventory (I) – Payables (P)	\$24m	\$25m	\$35m	\$31m	\$32m
(R + I – P) / Sales	19.9%	20.6%	28.7%	24.5%	24.6%

Working Capital Adjustment	Year 1	Year 2	Year 3	Year 4	Year 5
TestCo's (R + I – P) / Sales	25.6%	25.8%	24.1%	26.7%	29.3%
CompCo's (R + I – P) / Sales	19.9%	20.6%	28.7%	24.5%	24.6%
Difference (D)	5.7%	5.1%	-4.7%	2.1%	4.7%
Interest Rate (i)	4.8%	5.4%	5.0%	5.5%	4.5%
Adjustment (D*i)	<b>0.27%</b>	<b>0.28%</b>	<b>-0.23%</b>	<b>0.12%</b>	<b>0.21%</b>
CompCo's EBIT/Sales (%)	1.32%	2.96%	2.59%	3.31%	4.95%
<b>Working Capital Adjusted EBIT / Sales for CompCo</b>	<b>1.59%</b>	<b>3.24%</b>	<b>2.35%</b>	<b>3.43%</b>	<b>5.16%</b>

<sup>1</sup> See comment at paragraph 8.

8. Some observations:

- An issue in making working capital adjustments is what point in time are the Receivables, Inventory and Payables compared between the tested party and the comparables. The above example compares their levels on the last day of the financial year. This may not, however, be appropriate if this timing does not give a representative level of working capital over the year. In such cases, averages might be used if they better reflect the level of working capital over the year.
- A major issue in making working capital adjustments involves the selection of the appropriate interest rate (or rates) to use. The rate (or rates) should generally be determined by reference to the rate(s) of interest applicable to a commercial enterprise operating in the same market as the tested party. In most cases a commercial loan rate will be appropriate. In cases where the tested party's working capital balance is negative (that is Payables > Receivables + Inventory), a different rate may be appropriate. The rate used in the above example reflects the rate at which TestCo is able to borrow funds in its local market. This example also assumes that the same interest rate is appropriate for payables, receivables and inventory, but that may or may not be the case in practice. Where different rates of interest are found to be appropriately applicable to individual classes of assets or liabilities, the calculation may be considerably more complex than shown above.
- The purpose of working capital adjustments is to improve the reliability of the comparables. There is a question whether working capital adjustments should be made when the results of some comparables can be reliably adjusted while the results of some others cannot.