



## ***TRANSACTIONAL PROFIT METHODS***

### ***DISCUSSION DRAFT FOR PUBLIC COMMENT***

***25 January 2008***



CENTRE FOR TAX POLICY AND ADMINISTRATION

**RELEASE FOR PUBLIC COMMENT OF A SERIES OF ISSUES NOTES ON  
TRANSACTIONAL PROFIT METHODS**

1. As part of its procedures for monitoring the implementation of the Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (“the TP Guidelines”), Working Party No. 6 of the OECD Committee on Fiscal Affairs is examining the application of transactional profit methods (*i.e.*, the transactional profit split and the transactional net margin method).
2. An open invitation to comment on issues in relation to profit methods was released in February 2006 and attracted many detailed responses from the public (see invitation to comment at [http://www.oecd.org/document/58/0,3343,en\\_2649\\_37989753\\_36199290\\_1\\_1\\_1\\_1,00.html](http://www.oecd.org/document/58/0,3343,en_2649_37989753_36199290_1_1_1_1,00.html) and responses received from the public at [http://www.oecd.org/document/8/0,3343,en\\_2649\\_37989753\\_37422280\\_1\\_1\\_1\\_1,00.html](http://www.oecd.org/document/8/0,3343,en_2649_37989753_37422280_1_1_1_1,00.html)).
3. Comments are now invited on the attached series of Issues notes that was drafted by the Working Party, building on experience acquired by countries in applying transactional profit methods since the adoption of the TP Guidelines in 1995 and on comments received from the business community in response to the 2006 invitation.
4. Comments should be sent **by 30 April 2008** to Jeffrey Owens, Director of the OECD Centre for Tax Policy and Administration ([Jeffrey.Owens@oecd.org](mailto:Jeffrey.Owens@oecd.org)). Unless otherwise requested at the time of submission, comments submitted to the OECD in response to this invitation may be posted on the OECD website. Comments should be sent preferably electronically in Word format, to facilitate their reproduction in OECD documents.

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## 1. REVIEW OF TRANSACTIONAL PROFIT METHODS: STATUS AS LAST RESORT METHODS

### Introduction – Description of the issues

1. In the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (hereafter the “TP Guidelines”), traditional transaction methods are regarded as preferable to other methods. Transactional profit methods are described as last resort methods the use of which should be limited to those exceptional situations where there are no data available or where the available data are not of sufficient quality to rely solely or at all on the traditional transaction methods (see paragraphs 2.49, 3.49 and 3.54 of the TP Guidelines).

2. But since the publication of the TP Guidelines in 1995, an increasing number of countries indicate that in practice transactional profit methods are being used in far more cases than would be expected from their last resort status.

3. In the context of its review of transactional profit methods, Working Party No. 6 of the Committee on Fiscal Affairs is looking both at whether their last resort status should be maintained and at developing further practical guidance for the application of these methods. This issue note focuses on the first question *i.e.* whether or not to maintain the last resort status of transactional profit methods.

4. In order to inform a decision on that question, the Working Party had detailed discussions of the following issues:

- **Examination of the arguments in favour of maintaining the last resort status:** what the reasons were for giving transactional profit methods a last resort status in the TP Guidelines and whether there are new concerns that have arisen since 1995; assess the validity of these old and new concerns and whether there are ways to alleviate them.
- **Examination of the arguments in favour of changing the last resort status:** what the reasons are for many taxpayers and tax administrations to use transactional profit methods despite their last resort status and the arguments raised in favour of changing the status of these methods.
- **Examination of the various possible options with respect to the status of transactional profit methods:** what the options are (including whether different solutions should be promoted for the profit split methods and for the transactional net margin method (hereafter “TNMM”) or for specific transactions), their pros and cons, and what safeguards or conditions should be satisfied in order for these various options to be acceptable.

**A - Tentative conclusions reached by the Working Party**

5. Having discussed these issues in detail, the Working Party tentatively reached the following conclusions:

- The selection of a transfer pricing method always aims at finding the most appropriate method for a particular case.
- For this purpose, it should take account of the respective strengths and weaknesses of each of the OECD recognised methods; of the appropriateness of the method considered in view of the comparability (including functional) analysis of the controlled transaction under review; of the availability of sufficiently reliable information (in particular on uncontrolled comparables) in order to apply the selected method and / or other methods; of the degree of comparability of controlled and uncontrolled transactions including the reliability of comparability adjustments that may be needed to eliminate differences between them.<sup>1</sup> Each of these points is discussed in Sections A.1 to A.4 below.

6. The proposal by the Working Party is thus to remove the exceptionality and put a greater emphasis on the relative strengths and weaknesses of each method and on the importance of the comparability analysis, *i.e.* on the appropriateness of the method to the circumstances of the case. This does not mean in practice that the general preference for traditional transaction methods over transactional profit methods is simply abolished as the Working Party considers that traditional transaction methods have intrinsic strengths as discussed in Section A.1 below.

7. Where, taking account of the comparability analysis of the controlled transaction under review and of the availability of information, a traditional transaction method and a transactional profit method can be applied in an equally reliable manner, the traditional transaction method is generally to be preferred.

8. The Working Party's recommendation that the selection of a transfer pricing method always should aim at finding the most appropriate method for each particular case does not mean that all the transfer pricing methods should be analysed or tested in each case. The selection of the most appropriate method should follow from the application of a process similar to the typical search process that is proposed in the comparability paper that was released for public comment in May 2006 [page 45].<sup>2</sup>

***A.1 Strengths and weaknesses of each of the OECD recognised methods – Preference for traditional transaction methods in relevant circumstances***

9. The respective strengths and weaknesses of the OECD recognised methods and in particular of transactional profit methods are extensively discussed in the TP Guidelines. Some of this discussion needs to be updated to take account of the evolution of the practice since 1995 (see part B of this note for draft amendments to the relevant language in the TP Guidelines).

10. There is general agreement (among countries and among most of the business commentators who responded to the OECD questionnaire on profit methods) that traditional transaction methods are more direct methods than transactional profit methods. For this reason, where, taking account of the comparability analysis of the controlled transaction under review and of the availability of information, the

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1. Paragraph 1.70 of the TP Guidelines already notes that "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."

2. [http://www.oecd.org/document/12/0,3343,en\\_2649\\_33753\\_36651660\\_1\\_1\\_1\\_1,00.html](http://www.oecd.org/document/12/0,3343,en_2649_33753_36651660_1_1_1_1,00.html).

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. Similarly where, taking account of the comparability analysis of the controlled transaction under review and of the availability of information, a traditional transaction method and a transactional profit method can be applied in an equally reliable manner, the traditional transaction method is preferable.

### ***A.2 Appropriateness of the method considered in view of the comparability (including functional) analysis of the controlled transaction under review***

11. Countries have repeatedly expressed a serious concern that transactional profit methods are often used without a sufficiently reliable analysis especially with regard to comparability and the use of company-wide third party data. It is expected that the guidance that is in the process of being developed in the context of the review of comparability will be capable of alleviating this concern. If needed, it could be complemented by specific guidance on comparability requirements for applying profit methods.

12. It is recognised that there are situations where transactional profit methods can be more appropriate than traditional transaction methods in consideration of the comparability (including functional) analysis of the controlled transaction under review and that such situations are not exceptional. Examples include:

- Cases where, in consideration of the comparability (including functional) analysis of the controlled transaction under review and of the evaluation of comparable uncontrolled transactions, it is found that a net profit margin analysis is more reliable than a gross margin analysis. See also discussion of the selection and determination of the net profit margin indicator in a separate Issues note.
- Cases where the presence of significant non-benchmarkable<sup>3</sup> intangibles used by both parties to the controlled transaction makes a transactional profit split more appropriate than a one-sided method.

13. This discussion must be linked to the review of comparability and in particular to the description of a typical search process that is proposed in the comparability paper that was released for public comment in May 2006 [page 45]. In effect, when discussing what a typical search process should be, the Working Party considered that the choice of the relevant transfer pricing method(s) is to be made in step 6, after the broad-based analysis, the comparability (including functional) analysis of the controlled transaction under review, the review of internal comparables and the determination of available sources of information, *i.e.* the Working Party considered that the selection of the transfer pricing method(s) should derive from those preliminary steps. This is not a brand new concept: the functional analysis not only informs the choice between traditional transaction methods and transactional profit methods; it also informs the choice among traditional methods (for instance the cost plus and resale price methods have the same ranking in the TP Guidelines but are applied to different outcomes of functional analyses) and among transactional profit methods.

### ***A.3 Availability of sufficiently reliable information (in particular on uncontrolled comparables) to apply the selected method and / or other methods***

14. The business community explains and the OECD recognises that in practice, the application of traditional transaction methods is often constrained by the lack of reliable third party information to apply

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3. A definition will be added to the TP Guidelines' Glossary: "Benchmarkable functions, assets and risks are functions, assets and risks for which reasonably reliable comparables exist."

them. The problem is more or less acute depending on each country's public filing requirements which condition the availability and quality of public sources of information. It is recognised that in countries 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 satisfactory internal comparables.

#### **A.4 Reliability of comparability adjustments**

15. The reliability of comparability adjustments that may be needed to eliminate the differences between the controlled transaction under review and the "comparables" is one key factor that influences the quality of the comparison being made and accordingly that may influence the choice of the transfer pricing method that is regarded as the most appropriate to the circumstances of the case.

#### **B - Proposed amendments to the TP Guidelines**

16. On the basis of the above and of the discussion by the Working Party of the relative strengths and weaknesses of transactional profit methods, comments are invited on the following draft amendments to the existing language at paragraph 2.49 and at selected paragraphs of Chapter III of the TP Guidelines. Note that no final agreement on amendments to the language in the TP Guidelines can be reached before all the Issues examined in the review of comparability and in the review of transactional profit methods have been discussed and agreed and the Working Party can have a full picture of the proposed revision of the Chapters.

### *Chapter I*

#### **The Arm's Length Principle**

##### *x) Use of transfer pricing methods*

1.68 The methods set forth in Chapters II and III establish whether the conditions imposed in the commercial or financial relations between associated enterprises are consistent with the arm's length principle. No one method is suitable in every possible situation and the applicability of any particular method need not be disproved. The selection of a transfer pricing method always aims at finding the most appropriate method for a particular case. For this purpose, it should take account of the respective strengths and weaknesses of each of the OECD recognised methods; of the appropriateness of the method considered in view of the comparability (including functional) analysis of the controlled transaction under review; of the availability of sufficiently reliable information (in particular on uncontrolled comparables) in order to apply the selected method and/or other methods; of the degree of comparability of controlled and uncontrolled transactions including the reliability of comparability adjustments that may be needed to eliminate differences between them.

1.68a The OECD's recommendation that the selection of a transfer pricing method always should aim at finding the most appropriate method for each particular case does not mean that all the transfer pricing methods should be analysed or tested in each case. The selection of the most appropriate method should follow from the application of a process similar to the typical search process that is proposed [reference to be inserted here].

1.68b [From 1.68] Tax administrators should hesitate from making minor or marginal adjustments. Moreover, MNE groups retain the freedom to apply methods not described in this

Report to ~~establish~~ set prices provided those prices satisfy the arm's length principle in accordance with these Guidelines. However, a taxpayer should maintain and be prepared to provide documentation regarding how its transfer prices were ~~established~~ set. For a discussion of documentation, see Chapter V.

[...]

## *Chapter II*

### **Traditional Transaction Methods**

#### **D. Relationship to other methods**

2.49 As noted at paragraph 1.68 and 1.68a, the selection of a transfer pricing method always aims at finding the most appropriate method for a particular case. One essential element is to take account of the respective strengths and weaknesses of each of the OECD recognised methods. Traditional transaction methods are the most direct means of establishing whether conditions in the commercial and financial relations between associated enterprises are arm's length. As a result, where, taking account of the comparability analysis of the controlled transaction under review and of the availability of information, a traditional transaction methods and a transactional profit method can be applied in an equally reliable manner, the traditional transaction method is are preferable to ~~other~~ the transactional profit methods. Moreover, where, taking account of the comparability analysis of the controlled transaction under review and of the availability of information, 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.

2.49a However, there are situations where transactional profit methods are found to be more appropriate than the complexities of real life business situations may put practical difficulties in the way of the application of the traditional transaction methods in consideration of the comparability (including functional) analysis of the controlled transaction under review and of the evaluation of comparable uncontrolled transactions. See paragraph 3.2b.

In addition, where there is no or limited publicly available reliable gross margin information on third parties, traditional transaction methods might be ~~very~~ difficult to apply in cases other than those where there are satisfactory internal comparables and a transactional profit method might be the most appropriate method in view of the availability of sufficiently reliable information. ~~In those exceptional situations, where there are no data available or the available data are not of sufficient quality to rely solely or at all on the traditional transaction methods, it may become necessary to address whether and under what conditions other methods may be used. This issue, in particular the role of transactional profit methods and conclusions about their use, is~~ are discussed in Chapter III.

[...]

### Chapter III

#### ~~Other~~ Transactional profit methods

##### A. Introduction

3.1 Part B of this Chapter provides a discussion of ~~other approaches~~ transactional profit methods that might be used to approximate arm's length conditions when traditional transaction methods are found not to be the most appropriate methods in the circumstances of the case, see paragraph 3.2a below, cannot be reliably applied alone or exceptionally cannot be applied at all. ~~The other approaches are referred to in the discussion here as "Transactional profit methods," i.e. methods that 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 the profit split method or the transactional net margin method.~~ Article 9 of the OECD Model Tax Convention and follow the requirement for a sufficiently reliable 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. Part C discusses an approach that cannot reliably approximate arm's length conditions: global formulary apportionment. OECD Member countries reiterate their support for the arm's length principle and so reject the use of global formulary apportionment.

##### B. Transactional profit methods

3.2 A transactional profit method examines the profits that arise from particular controlled transactions. The transactional profit methods for purposes of these Guidelines are the profit split method and the transactional net margin method. It is unusual to find enterprises entering into transactions in which profit is a condition "made or imposed" in the transactions. ~~In fact, enterprises rarely if ever use a transactional profit method to establish their prices.~~ Nonetheless, 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.

3.2a The selection of a transfer pricing method always aims at finding the most appropriate method for a particular case, see paragraphs 1.68 and 1.68a. It should take account of the respective strengths and weaknesses of each of the OECD recognised methods; of the appropriateness of the method considered in view of the comparability (including functional) analysis of the controlled transaction under review; of the availability of sufficiently reliable information (in particular on uncontrolled comparables) to apply the selected method and / or other methods; of the degree of comparability of controlled and uncontrolled transactions, including the reliability of comparability adjustments that may be needed to eliminate differences between them.

3.2b Transactional profit methods may be more appropriate than traditional transaction methods in cases where, for example, in consideration of the comparability (including functional) analysis of the controlled transaction under review and of the evaluation of the comparable uncontrolled transactions, it is found that a net profit margin analysis is more reliable than a gross margin analysis (e.g. because there are operating expenses below the gross margin level for which the tested party is not responsible); in cases where the presence of significant non-benchmarkable contributions (e.g. intangibles) by each of the parties to the controlled transaction or the engagement in highly integrated activities makes a transactional profit split more appropriate than a one-sided method; and in cases where there are no reasonably reliable satisfactory internal

comparables, and no or limited publicly available gross margin information on third parties to apply a traditional transaction method in a reasonable reliable manner and where a transactional profit method can be applied in a reasonably reliable manner.

3.2c Thus, in those ~~exceptional~~ cases in which ~~the complexities of real life business put practical difficulties in the way of the application of~~ the traditional transaction methods are found not to be the most appropriate methods to the circumstances of the case and provided all the safeguards set out in this Chapters I and III of these Guidelines are observed, in particular the requirement for a sufficiently reliable comparability analysis, application of the transactional profit methods (profit split and transactional net margin method) may provide an approximation of transfer pricing in a manner consistent with the arm's length principle.

3.2d However, the transactional profit methods may not be applied automatically simply because there is a difficulty in obtaining data. The same factors that led to the conclusion that it was not possible to reliably apply a traditional transaction method must be reconsidered when evaluating the reliability of a transactional profit method. Rather, the reliability of a method should be assessed taking into account the principles discussed in this Report, including the extent and the reliability of adjustments to the data used.

3.3 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, which requires that the profits arising from particular controlled transactions be compared to the profits arising from comparable transactions between independent enterprises.

3.4 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 when the reason for their lack of success is attributable to commercial factors.

#### *i) Profit split method*

Note: conforming changes will be needed with language agreed in the context of the Issues notes on the profit split method.

##### *a) In general*

3.5 Where transactions are very ~~interrelated~~ integrated, for instance in the global trading of financial instruments, it might be that they cannot be evaluated on a separate basis. Similarly, where there are significant non-benchmarkable contributions (e.g. intangible assets) by each party to a controlled transaction, the use of a one-sided method might not be appropriate. Under similar circumstances, independent enterprises might decide to set up a form of partnership and agree to a form of profit split. Accordingly, the 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 Chapter I) by determining the division of profits that independent enterprises would have expected to realise from engaging in the transaction or transactions. The profit split method first identifies the profit to be split for the associated enterprises from the controlled transactions in which the associated enterprises are engaged. It then splits those 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. The combined profit may be the total profit from the transactions or a residual profit intended to represent the profit that cannot readily be assigned to one of the parties, such as the profit arising from high-value, sometimes unique, intangibles. The contribution of each enterprise is based upon a functional analysis as described in Chapter I, and valued to the extent possible by any available reliable external market data. The functional analysis is an analysis of the functions performed (taking into account assets used and risks assumed) by each enterprise. The external market criteria may include, for example, profit split percentages or returns observed among independent enterprises with comparable functions. Subsection *c)* of this Section provides guidance for applying the profit split method.

*b) Strengths and weaknesses*

3.5a The main strength of the profit split method is that it offers a solution to deal with cases where there is an absence of reliable comparables, such as might occur when valuable, non-benchmarkable or highly specialised intangibles are used by each party to a transaction. Similarly, the profit split method can offer a solution for highly integrated operations for which a one-sided method would not be appropriate.

~~3.6 One strength of the profit split method is that it generally does not rely directly on closely comparable transactions, and it can therefore be used in cases when no such transactions between independent enterprises can be identified. The allocation of profit is based on the division of functions between the associated enterprises themselves. External data from independent enterprises is relevant in the profit split analysis primarily to assess the value of the contributions that each associated enterprise makes to the transactions, and not to determine directly the division of profit. As a consequence, the profit split method 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. [Note: see further proposed amendments to paragraph 3.6 in the note "Application of a transactional profit split method: how to split the combined profit, page 64.]~~

3.6a In a profit split method, the allocation of the combined profits is based on the relative contributions of the associated enterprises to the transaction. Although external data from independent enterprises may be relevant in assessing the value of the contributions that each associated enterprise makes to the transaction, it will generally be less closely connected to those transactions than is the case with the other available methods. The more tenuous the nature of the external market data used when applying the profit split method, the more subjective will be the resulting allocation of profits. Notwithstanding these concerns, experience shows that in certain cases the profit split method may in fact be reliably applied without external data to support the relative contributions of the associated enterprises.

~~3.7 Another strength is that under the 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.~~

3.8 ~~There are also a number of weaknesses to the profit split method. One such weakness is that 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. The more tenuous the nature of the external market data used when applying the profit split method, the more subjective will be the resulting allocation of profits.~~

3.9 ~~A second~~ One weakness relates to difficulties in applying the profit split method. On first review, the 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. Moreover, independent enterprises do not ordinarily use the profit split method to determine their transfer pricing (except perhaps in joint ventures). 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 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. Practical guidance on how to apply a profit split method is found under section c) below. It is expected that there will be less practical difficulty when a profit split method is applied in the context of a MAP or MAP APA.

3.10 The foregoing considerations should be taken into account in determining whether any particular application of the profit split method is appropriate given the facts and circumstances. More importantly, because of the foregoing considerations, the application of the profit split method is subject to the conclusions and limitations on transactional profit methods set forth in Section *iii*).

[...]

*ii) Transactional net margin method*

Note: conforming changes will be needed with language agreed in the context of the Issues notes on the transactional net margin method.

*a) In general*

3.26 The transactional net margin method examines the net profit margin relative to an appropriate base (*e.g.* costs, sales, assets) that a taxpayer realizes from a controlled transaction (or transactions that are appropriate to aggregate under the principles of Chapter I). 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 margin of the taxpayer from the controlled transaction (or transactions that are appropriate to aggregate under the principles of Chapter I) should ideally be established by reference to the net margin that the same taxpayer earns in comparable uncontrolled transactions *i.e.* by reference to “internal comparables”. 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. A functional analysis of the ~~associated enterprise and, in the latter case, the independent enterprise~~ 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 3.34-3.40, must be applied.

3.26a The OECD has expressed a general preference for internal comparables [Note: reference to be included here to the appropriate paragraphs of the TP Guidelines once revised to take account of the outcome of the review of comparability] while recognising that satisfactory internal comparables do not always exist and that searches for external comparables are often needed in practice. Where internal comparables are available, it is generally possible to apply a traditional transaction method. Accordingly, before using a transactional net margin method, taxpayers and tax administrations are invited to first examine whether satisfactory internal comparables exist that could support a traditional transaction method. In the absence of satisfactory internal comparables, the availability and reliability of external comparables will be an important factor to take into account in the choice of the method, see in particular paragraph 1.68.

*b) Strengths and weaknesses*

3.27 One strength of the transactional net margin method is that net margins (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. The net margins 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, enterprises may have a wide range of gross profit margins but still earn broadly similar levels of net profits. In addition, the lack of clarity in the public data with respect to the classification of expenses in the gross or operating margin frequently makes it difficult to evaluate the comparability of gross margins, while the use of net margins finesses the problem.

3.28 Another practical strength of the transactional net margin method is that, as with any one-sided method, it is not necessary to determine the functions performed and responsibilities assumed by examine a financial indicator for more than one of the associated enterprises (the “non-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 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 qualitative information be collected on both the tested and the non-tested party.

3.29 There are also a number of weaknesses to the transactional net margin method. Perhaps the greatest weakness is that the net margin of a taxpayer can be influenced by some factors that would either ~~do~~ not have an effect, or have a less substantial or direct effect, on price or gross margins between independent parties at arm’s length. These aspects may make accurate and reliable determinations of arm's length net margins difficult. Thus, it is important to provide some detailed guidance on establishing comparability for the transactional net margin method, as set forth in subsection c)(1) below.

3.30 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 averages data as discussed in paragraphs 1.49 through

1.51 may mitigate this concern). In addition, taxpayers may not have access to enough specific information on the profits attributable to 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 financial return used as the profit measure for the transactions. Tax administrators may have more information available to them from examinations of other taxpayers. However, as with any other method, it would be unfair to apply the transactional net margin method on the basis of such data unless the data can be disclosed (within the limits of the confidentiality requirements of tax laws) to the taxpayer so that there is an adequate opportunity for the taxpayer to defend its own position and to safeguard effective judicial control by the courts.

3.31 One other issue that arises for the transactional net margin method is that the method is typically applied to only one of the associated enterprises. This one-sided aspect does not distinguish the method from most other methods, given that the resale price and cost plus methods also have this feature. However, the fact that many factors unrelated to transfer prices can affect net margins and can render the transactional net margin method less reliable heightens the concerns over a one-sided analysis. A one-sided analysis may not take into account the overall profitability of the MNE group from the controlled transactions for purposes of comparability. A one-sided analysis potentially can attribute to one member of an MNE group a level of profit that implicitly leaves other members of the group with implausibly low or high profit levels. While the impact on the profits of the other parties to a transaction is not always a conclusive factor in determining the pricing of a transaction, it may act as a counter-check of the conclusions reached.

3.32 There may also be serious 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.

3.33 The foregoing considerations should be taken into account in determining whether any particular application of the transactional net margin method is appropriate given the facts and circumstances of a case. More importantly, because of the foregoing considerations, the application of the transactional net margin method is subject to the conclusions and limitations on transactional profit methods set forth in Section *iii*).

[...]

*iii) Conclusions on transactional profit methods*

3.49 As noted at paragraphs 1.68 and 1.68a, the selection of a transfer pricing method always aims at finding the most appropriate method for a particular case. One essential element is to take account of the respective strengths and weaknesses of each of the OECD recognised methods. Traditional transaction methods are the most direct means of establishing whether conditions in the commercial and financial relations between associated enterprises are arm's length. As a result, where, taking account of the comparability analysis of the controlled transaction under review and of the availability of information, 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 comparability analysis of the controlled transaction under review and of the availability of information, 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. Traditional transaction methods are to be

~~preferred over transactional profit methods as a means of establishing whether a transfer price is at arm's length, i.e. whether there is a special condition affecting the level of profits between associated enterprises. To date, practical experience has shown that in the majority of cases, it is possible to apply traditional transaction methods.~~

3.50 There are, however, cases where transactional profit methods are found to be more appropriate than traditional transaction methods in consideration of the comparability (including functional) analysis of the controlled transaction under review and of the evaluation of comparable uncontrolled transactions, see paragraph 3.2b. ~~cannot be reliably applied alone or exceptionally cannot be applied at all. These would be considered cases of last resort. Such cases arise only where there is insufficient data on uncontrolled transactions (possibly because of uncooperative behaviour on the part of the taxpayer relative to these Guidelines), or where such data are considered unreliable, or due to the nature of the business situation. In such cases, of last resort, practical considerations may suggest application of a transactional profit method may be applied either in conjunction with traditional transaction methods or on its own. However, even in a case of last resort, it would be inappropriate to automatically apply a transactional profit method without first considering the reliability of that method. See in particular paragraphs 3.9 and 3.31. The same factors that led to the conclusion that it was not possible to reliably apply a traditional transaction method must be reconsidered when evaluating the reliability of a transactional profit method. Thus, if it is necessary to aggregate transactions to apply a transactional profit method and if it is possible to aggregate the same transactions and apply a traditional transaction method, the effect of such aggregation on the reliability of both methods must be considered. Therefore, for the reasons set out in this Report and particularly those in paragraphs 3.52-3.57 below, as a general matter the use of transactional profit methods is discouraged.~~

3.51 A transactional profit method also may be used in cases where application of the method is agreed to be appropriate by the associated enterprises affected by the transactions and by the tax administrations in the jurisdictions of those associated enterprises. Transactional profit methods may also provide a useful means of identifying cases that may require further investigation.

3.52 ~~In most countries the application of transactional profit methods has been limited to the profit split method, the use of which has not been frequent and has taken place largely in bilateral agreement procedures—situations where the risk of unrelieved double taxation is minimal. Very few countries have much experience in the application of the transactional net margin method and most consider it experimental and therefore prefer to use the profit split method in cases of last resort.~~

3.53 As discussed in this Report, there are substantial concerns regarding the use of the transactional net margin method, in particular that it ~~may be~~ is sometimes applied without adequately taking into account the relevant differences between the ~~associated enterprises controlled and the independent enterprises 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 ~~enterprises transactions~~ being compared have a material effect on the net margins being used, it would not be appropriate to apply the transactional net margin method without making adjustments for such differences. See ~~Paragraphs~~ Paragraphs 3.34-3.40 (the comparability standard to be applied to the transactional net margin method).

3.54 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. ~~Instead, transactional profit methods are being recognised as methods that assist in determining in cases of last resort whether transfer pricing complies with the arm's length principle.~~ 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 Chapter I.

~~3.55 The present lack of experience with the application of transactional profit methods across a representative number of OECD Member countries makes it difficult to fix, with precision, all the limitations on the use of these methods that it may prove appropriate to establish. For this reason, and because of concerns with transactional profit methods more generally, the Committee on Fiscal Affairs will undertake an intensive period of monitoring the application of both traditional transaction methods and transactional profit methods over the coming years, with a view to revising this Report periodically, as necessary, to take into account the results of the monitoring. It is anticipated that the monitoring will include not only peer reviews of the practices of OECD Member countries but also a review of any problematic cases that tax administrations or taxpayers may identify for consideration by the Committee during the review period. To facilitate this process, countries are encouraged to keep such records as are feasible on the application of transfer pricing methods, the frequency with which transactional profit methods are applied, and why recourse was had to those methods. More generally all countries should be aware of the need to apply the guidelines set out in this Report in an equitable and balanced manner as between the States concerned in order to avoid double taxation.~~

3.56 In all cases, considerable 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 (see paragraph 3.50). 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. Consequently, transactional profit methods should never be used by tax administrations if they do not yet have the necessary institutional legal framework to ensure that the proper precautions are taken. This would include the existence of an effective administrative appeals mechanism. The Committee on Fiscal Affairs intends to engage the major non Member countries in a dialogue on the application of the principles and methods set out in this Report and any revisions hereto.

3.57 A tax administration that is asserting the application of a transactional profit method should be particularly conscious of its burden in demonstrating to the tax administration of the other State in any mutual agreement proceedings that such approach is being appropriately applied and achieves the best approximation of arm's length pricing in all the facts and circumstances of the case. Tax administrations also should be conscious of relevant burden of proof rules in applicable arbitration proceedings.

## 2. USE OF MORE THAN ONE METHOD (USE OF A TRANSACTIONAL PROFIT METHOD IN CONJUNCTION WITH A TRADITIONAL TRANSACTION METHOD, OR SANITY CHECK)

### Introduction – Description of the issue

17. As noted at paragraph 1.69 of the TP Guidelines:

“The arm's length principle does not require the application of more than one method, and in fact undue reliance on such an approach could create a significant burden for taxpayers. Thus, [the TP Guidelines do] not require either the tax examiner or taxpayer to perform analyses under more than one method.”

18. Some guidance on the use of more than one method in complex cases is however found in the following language at paragraph 1.69 of the TP Guidelines:

“While in some cases the choice 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.”

19. The TP Guidelines also recognise in several places that there are cases where traditional transaction methods cannot be reliably applied alone, thus suggesting transactional profit methods can in some instances usefully supplement traditional methods (see for instance paragraph 3.50).<sup>4</sup>

20. Most of the comments received from the business community in response to the questionnaire on profit methods reflect broad agreement that using a second method to assess the reasonableness of the results of the application of a first method might be appropriate in some cases. Business commentators however urge the OECD to confirm that using more than one method should not be a requirement under any circumstance. The business community considers that a mandatory requirement for more than one transfer pricing method to be applied would lead to an overly onerous and unnecessary compliance burden to taxpayers.

21. Having discussed this issue, the Working Party concluded that the current standard described at paragraph 1.69 of the TP Guidelines should be maintained *i.e.* the use of more than one method for a given transaction (or set of transactions that are appropriately aggregated following the guidance at paragraph 1.42 of the TP Guidelines) is not a requirement under the arm's length principle but might be useful in

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4. In some cases two traditional transaction methods can be used, *e.g.* the cost plus method may supplement the resale price method, see paragraph 2.24 of the TP Guidelines.

appropriate cases. This of course does not mean that the same transfer pricing method can necessarily be applied to all the transactions of a taxpayer.

22. Since the TP Guidelines were approved in 1995, taxpayers and tax administrations have gained experience on the application of a transactional profit method (profit split or transactional net margin method) in conjunction with a traditional transaction method, for instance where the results of applying a traditional method alone are uncertain or in the context of a residual profit split method (see Section A below).

23. In addition, there are cases where a secondary method is applied either by the taxpayer or by the tax administration to test the plausibility of the outcome of a primary method, for instance as part of a risk assessment procedure (as discussed in Section B below). Where a secondary method is used as a sanity check to test the outcome of a primary method, the latter remains the applicable method and the secondary method is only used to identify unusual outcomes that would suggest the need to further review the choice and application of the primary method. A method however should not be rejected just because it produces an outcome that the person (taxpayer or tax administration) making the analysis does not like.

24. As a consequence, depending on the facts and circumstances of the case, it may be appropriate either to use one method only, or to use more than one method in conjunction, or to test the outcome of a primary method with a secondary method.

#### **A - Use of a transactional profit method in conjunction with a traditional transaction method**

##### ***A.1 Use of a transactional profit method in conjunction with a traditional transaction method***

25. Paragraphs 1.46-1.47 of the TP Guidelines contain some guidance in relation to the use of more than one method to evaluate a controlled transaction, in particular in cases where two methods attain similar degrees of comparability.

26. Paragraphs 1.69 and 3.50 of the TP Guidelines note that transactional profit methods may be used in conjunction with a traditional transaction method in complex cases where the outcome of a single method is uncertain. On the basis of comments received from countries and from the business community, the following instances were identified where a transactional profit method may be used in conjunction with a traditional transaction method:

- Where there is no single sufficiently reliable comparable but multiple sources of data which are all equally reasonably comparable for evaluation under a transfer pricing analysis (*e.g.* comparable transactions data to apply a CUP and comparable company data to apply a TNMM), use of more than one method in conjunction could be appropriate in order to encourage the use of all available data to the extent that the data will help inform the arm's length determination;
- If, under the particular circumstances, it is unclear which method provides the most reliable results, an additional factor that may be taken into account is whether competing methods produce results that are consistent with each other. While the choice of the method should not be outcome-oriented, consistent outcomes might in such circumstances provide additional comfort in the determination of the arm's length price.

27. There are also cases of application of a transactional profit method in conjunction with a traditional transaction method where a transaction takes place between a country that accepts transactional profit methods and one that does not.

**A.2 Use of a residual profit split method that starts with traditional transaction methods to determine the initial arm's length remuneration attributed to benchmarkable functions**

28. A different situation is the use of a residual profit split method starting with the application of traditional transaction methods to determine the initial arm's length remuneration attributed to benchmarkable functions (see paragraphs 3.19 - 3.20 of the TP Guidelines), followed by a contribution analysis to allocate the residual profit.

**Comments are invited from the business community on the instances described under Section A where a transactional profit method may be used in conjunction with a traditional transaction method.**

**B - Use of a sanity check to test the plausibility of the outcome of a primary method**

**B.1 Consequences of using a sanity check**

29. Sanity checks are not compulsory and should not be required from taxpayers. There are however circumstances in which they are found useful. Where a transactional profit method is used as a sanity check to test the outcome of another method (whether a traditional transaction method or another transactional profit method), the latter remains the primary method and the transactional profit method is only used to identify unusual outcomes that would suggest the need to further review the choice and application of the primary method.

30. For instance, the application of a resale price method (primary method) can be tested using a TNMM (secondary method) and found to lead to unusual net margin rates; or the application of cost plus or resale price method (primary method) can be tested using a transactional profit split and found to lead to an implausible sharing among the parties of the profits derived from the controlled transactions.

Such situations would lead to re-examine:

- Whether the method that was selected as the primary method was actually the most appropriate method and
- Whether it was correctly implemented, *i.e.* whether the comparability analysis was well done, in particular the functional analysis (for instance whether intangibles have been omitted or wrongly allocated) and the selection of "comparables".

31. It might be the case that the sanity check makes it possible to identify that there was an error either in the choice or in the application of the primary method, in which case the error would need to be corrected. For instance, assume a traditional transaction method is used as the primary method, and tested using a transactional net margin method. If the outcome of the transactional net margin method is unusual, the choice and application of the traditional transaction method should be reviewed. It is possible that this review reveals that the selected traditional method was not in fact the most appropriate method to the case, or that it was not properly implemented. In that case it would be necessary either to change the method or to correct its application. It would not be appropriate to substitute the secondary method (transactional net margin method in this example) to the primary method (a traditional transaction method in this case) unless the analysis reveals that in fact the secondary method is the most appropriate method.

32. In case the review confirms that the primary method is the most appropriate method and was properly implemented, its outcome should not be rejected just because it gives an unusual net margin or profit split.

33. In some instances, the sanity check might lead to questioning the arm's length nature of the results derived by the primary method in light of broader business considerations. An example would be where the primary method is a resale price and a sanity check performed using a transactional net margin method reveals that the outcome is a long-lasting loss-making position at the level of the net margin.

## ***B.2 Cases where the use of a sanity check could be appropriate***

34. Several business commentators who responded to the questionnaire consider that the use of a second method as a sanity check might be useful:

- For significant and material controlled transactions;
- In restructuring cases;
- From a risk management perspective.

35. Below is a discussion of situations where a transactional profit method can be used to test the outcome of either a traditional transaction method (sub-Section (i) ) or of another transactional profit method (sub-Section (ii) ).

*(i) Use of a transactional profit method as a sanity check to test the plausibility of the outcome of a traditional transaction method*

36. The TP Guidelines contain very limited guidance on when and how to use transactional profit methods to test the plausibility of the outcome of a traditional transaction method. Paragraph 2.38 provides a limited list of circumstances where it may be appropriate to supplement the cost plus and resale price methods by considering the results obtained from applying other methods where there are differences in the level and types of expenses associated with functions performed and risks assumed by the parties or transactions being compared.

37. Based on country and business comments received, other cases of application of a transactional profit method to test the outcome of a traditional transaction method could be:

- To increase the accuracy of conclusions (for example by producing overlapping ranges which enable comparable cases to be identified more closely);
- To establish the reliability of a primary traditional transaction method which has required significant comparability adjustments to be made;
- Where the taxpayer or tax administration has concerns about the comparability of the data available;
- To check the continuing suitability of the transfer pricing method used in practice and to check the consistency of the current period's result with those of previous periods;
- When the use of a traditional method leads to an outcome that appears commercially unrealistic with respect to the controlled transaction.

*(ii) Use of a transactional profit method as a sanity check to test the plausibility of the outcome of another transactional profit method*

(a) Use of a transactional profit split to test the outcome of a transactional net margin method

38. It was suggested that it might be useful in some circumstances to corroborate the conclusion of a TNMM with a profit split method, in order to avoid that a disproportionate amount of profit accrues to the tested party in comparison with the consolidated revenue of the transaction. The OECD, while recognising that such sanity checks might be useful in the conditions described under section B.1 above, does not support the notion that benchmarkable functions should be remunerated differently depending on the profitability of the group as a whole.

(b) Use of a transactional net margin method to test the outcome of a transactional net margin method using a different net profit margin indicator

39. In some cases, the use of a TNMM based on one net profit margin indicator to check the outcome of a TNMM based on another net profit margin indicator may be valuable, particularly when closely comparable data are not available.

**Comments are particularly invited from the business community on the instances described under Section B.2 where a transactional profit method may be used as a sanity check to test the plausibility of the outcome of a primary method.**

## C - Preliminary conclusion

40. There is consensus among member countries that the existing standard at paragraph 1.69 of the TP Guidelines should be maintained *i.e.* that “[t]he arm's length principle does not require the application of more than one method, and in fact undue reliance on such an approach could create a significant burden for taxpayers. Thus, [the TP Guidelines do] not require either the tax examiner or taxpayer to perform analyses under more than one method”. This standard is also largely supported by business commentators.

41. It would be useful however to provide more guidance in the TP Guidelines on the use of more than one method, in particular to clarify that the consequences of a sanity check, in those cases where the outcome of the test is unusual, should be to review the choice of the primary method and its application (comparability analysis in particular). The OECD does not support an outcome-oriented approach, *i.e.* the mere fact that the outcome of a sanity check is unusual is not sufficient in itself to reject the choice of the primary method. Examples could also be included in the TP Guidelines of when the use of two methods either in conjunction or as a sanity check might be useful.

42. Language to that effect could be added to Chapter I, section C (x) of the TP Guidelines. Below is a tentative draft that is submitted for comments. Note that no final agreement on amendments to the language in the TP Guidelines can be reached before all the Issues examined in the review of comparability and in the review of profit methods have been discussed and agreed and the Working Party can have a full picture of the proposed revision of the Chapters.

### *x) Use of transfer pricing methods*

[...]

1.69 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 1.42, and in fact undue reliance on such an approach could create a significant burden for taxpayers. Thus, this Report does not require either the tax examiner or

taxpayer to perform analyses under more than one method. While in some cases the choice 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.

1.69a The following instances were identified where a transactional profit method may be used in conjunction with a traditional transaction method:

- Where there is no single sufficiently reliable comparable but multiple sources of data which are all equally reasonably comparable for evaluation under a transfer pricing analysis (e.g. comparable transactions data to apply a CUP and comparable company data to apply a TNMM), use of more than one method in conjunction could be appropriate in order to encourage the use of all available data to the extent that the data will help inform the arm's length determination;
- If, under the particular circumstances, it is unclear which method provides the most reliable results, an additional factor that may be taken into account is whether competing methods produce results that are consistent with each other. While the choice of the method should not be outcome-oriented, consistent outcomes might in such circumstances provide additional comfort in the determination of the arm's length price.

1.69b In other cases, a secondary method might be used as a sanity check to test the plausibility of the outcome of the method used. Sanity checks are not compulsory and should not be required from taxpayers. There are however circumstances in which they are found useful.

1.69c See paragraph 2.38 for examples of circumstances where it may be appropriate to supplement the cost plus and resale price methods by considering the results obtained from applying other methods where there are differences in the level and types of expenses associated with functions performed and risks assumed by the parties or transactions being compared. The following other instances were identified where a transactional profit method could be used to test the outcome of a traditional transaction method:

- To increase the accuracy of conclusions (for example by producing overlapping ranges which enable comparable cases to be identified more closely);
- To establish the reliability of a primary traditional transaction method which has required significant comparability adjustments to be made;
- Where the taxpayer or tax administration has concerns about the comparability of the data available;
- To check the continuing suitability of the transfer pricing method used in practice and to check the consistency of the current period's result with those of previous periods;
- When the use of a traditional method leads to an outcome that appears commercially unrealistic with respect to the controlled transaction.

1.69d It was suggested that it might be useful in some circumstances to corroborate the conclusion of a TNMM with a profit split method, in order to avoid that a disproportionate amount of profit accrues to the tested party in comparison with the consolidated revenue of the transaction. The OECD, while recognising that such sanity checks might be useful in certain circumstances, does not support the notion that benchmarkable functions should be remunerated differently depending on the profitability of the group as a whole.

1.69e In some cases, the use of a TNMM based on one net profit margin indicator to check the outcome of a TNMM based on another net profit margin indicator may be valuable, particularly when closely comparable data are not available.

1.69f Where a secondary method is used as a sanity check to test the outcome of a primary method (whether a traditional transaction method or a transactional profit method), the latter remains the applicable method and the secondary method is only used to identify unusual outcomes that would suggest the need to further review the choice and application of the primary method. A method should not be rejected just because it produces an unusual outcome.

1.69g In some instances, the sanity check might lead to questioning the arm's length nature of the results derived by the primary method in light of broader business considerations. An example would be where the primary method is a resale price and a sanity check performed using a transactional net margin method reveals that the outcome is a long-lasting loss-making position at the level of the net margin.

1.70 Depending on the facts and circumstances of the case, it may be appropriate either to use one method only, or to use more than one method in conjunction, or to test the outcome of a primary method with a secondary method. It is not possible to provide specific rules that will cover every case. 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.

### 3. ACCESS TO THE INFORMATION NEEDED TO APPLY OR REVIEW THE APPLICATION OF A TRANSACTIONAL PROFIT METHOD

Note: The comments in this note relate to the application of a transactional profit 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 reliable method to be used.

#### Introduction – Description of the issue

43. Access to information is a key issue in the application and review of all transfer pricing methods. While most of the issues are not peculiar to transactional profit methods, some specific comments might be useful with respect to both the transactional profit split and the transactional net margin methods.

44. In some cases, it is the lack of sufficient information to reliably apply a traditional transaction method that leads to the decision to apply a transactional profit method, either in lieu of or to supplement the traditional transaction method.

45. In some other cases, the application or review of a transactional profit method is constrained by the difficulty for the taxpayer or tax administration to obtain the necessary information (*e.g.* transactional information at the net margin level where a transactional profit method is applied at the net margin level; information that may be needed on foreign related parties). In general business commentators who have responded to the OECD questionnaire on profit methods recognise that tax administrations should be given access to “all relevant information needed to review the application of the transfer pricing method applied”. Different views were expressed however on the extent of information that should be considered as relevant in each particular case.

46. Access to information is closely related to documentation issues. In the context of the elaboration of its 2007-08 Programme of Work, the Working Party discussed the scope for a possible project on transfer pricing documentation, recognising that the development of new guidance might be considered to take account of the outcome of the reviews of comparability and of profit methods. It was noted in particular that the review of profit methods might highlight the need for specific documentation requirements in relation to these methods, for instance documentation pertaining to the foreign related parties involved in a controlled transaction where a profit split method is applied to that transaction.

47. The Working Party however decided not to launch a project on transfer pricing documentation in 2007-08 due to its already heavy Programme of Work. In these circumstances, a discussion of general documentation requirements is not in the scope of this paper. It is also recognised that documentation requirements are fixed by domestic laws. The discussion in this note is limited to the following issues and to whether they could usefully be clarified in Chapter V of the TP Guidelines:

- Cases where a tax administration requests information on a foreign associated enterprise because it considers such information to be needed in order to review the taxpayers' application of a transactional profit method (Section A);
- Cases where a tax administration requests information on the taxpayer's cost accounting or management accounts (Section B).

48. The difficulties linked with the need to obtain information on third party comparables was extensively discussed by the Working Party in the context of the review of comparability. In this respect, issues specific to transactional profit methods include issues in relation to the identification of third party transactional information; the relative ease to find net margin versus gross margin information on third party comparables; the quality and reliability of database searches; use of non domestic comparables; and issues in relation to accounting standards.

**A - Cases where a tax administration requests information on a foreign associated enterprise because it considers such information to be needed in order to review the taxpayers' application of a transactional profit method**

49. Paragraph 5.11 of the TP Guidelines notes that “In many cases, information about foreign associated enterprises is essential to transfer pricing examinations. However, gathering such information may present a taxpayer with difficulties that it does not encounter in producing its own documents. When the taxpayer is a subsidiary of a foreign associated enterprise or is only a minority shareholder, information may be difficult to obtain because the taxpayer does not have control of the associated enterprise.”

50. Many business commentators who responded to the OECD questionnaire on profit methods recognise that depending on the transfer pricing method used, tax administrations may need some information on foreign associated enterprises. They however urge the OECD to acknowledge that “the requirements placed on a taxpayer to provide information relating to an overseas associated enterprise with which the transaction was entered into should recognise that there may be limitations on what supplementary information can be provided by the taxpayer relating to that associate.”

51. Two major concerns are raised by the business community:

- Confidentiality issues and whether a taxpayer can be required to provide information on a separate legal entity that is not in its control. This issue is already acknowledged at paragraphs 5.10 – 5.11 of the TP Guidelines.
- Whether taxpayers can be required to provide more information on foreign related parties to a transaction that what independents at arm's length would be able to obtain.

52. The Working Party discussed these issues and concluded that:

- (i) Irrespective of whether the transfer pricing method<sup>5</sup> is a one-sided or a two-sided method, information is needed on the five comparability factors and in particular on the functions, assets and risks of all the parties to a controlled transaction, including the foreign related party(ies). The Working Party discussed the statement at paragraph 3.28 of the TP Guidelines that “Another practical strength [of TNMM] is that it is not necessary to determine the functions performed and responsibilities assumed by more than one of the associated enterprises” and considered this statement needed to be fixed as it is not an accurate one. In effect, the Working Party considers that while one-sided methods (*e.g.* TNMM, cost plus or resale price methods) only require examining a financial indicator or profit level indicator for one of the parties to the transaction (the “tested party”), a comparability (including functional) analysis must be performed in order to appropriately characterise the transaction between the parties and choose the most reliable transfer pricing

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5. This can be the primary or the secondary method in the case where a secondary method is used as a sanity check, see Issues note on use of more than one method.

method to use. This analysis necessitates that some qualitative information be collected also on the non-tested party.<sup>6</sup>

- (ii) Where the transfer pricing method<sup>5</sup> is a two-sided method (*e.g.* 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 related party to the transaction. This includes qualitative information (review of the five comparability factors in order to appropriately characterise the relationship between the parties and justify the recourse to the transactional profit split method) as well as financial information (the determination of the combined profit to be split and the splitting of the profit both rely on financial information pertaining to all the parties to the transaction, including the foreign related party). Accordingly, it would be reasonable to expect that taxpayers who intend to use a transactional profit split method be ready to provide tax administrations with the necessary information on the foreign related party to the transaction, including the financial data necessary to calculate the profit split.
- (iii) Where the transfer pricing method<sup>5</sup> is a one-sided method, financial information on the tested party is needed – irrespective of whether the tested party is a domestic or foreign entity. So if the method to be used is a resale price or a TNMM and the tested party is the foreign resident, the tax administration of the country of the non-tested party also needs to have sufficient information to be able to review the application of the method to the foreign related party. On the other hand, if the method is a resale price or sales-based TNMM and the tested party is the domestic taxpayer, the tax administration generally has no reason to ask for information about the manufacturing costs of the foreign related party.

## **B - Cases where a tax administration requests information on the taxpayer's cost accounting**

53. Transactional net margins are generally not found in the statutory accounts. Their determination necessitates an allocation of costs and revenues that may be done – or not – by a taxpayer as part of its cost accounting. This means that the application and testing of a TNMM at the transactional, business line or product line level may require some information to be processed by the taxpayer that otherwise would not be processed for non-tax reasons.

54. Where net margin information exists at the transactional, business line or product line level, it is not always accessible to tax authorities (depending on local audit procedures) as this is information that typically goes beyond the traditional statutory and tax requirements. Several countries however consider that any information that is available to the taxpayer and relevant to the determination of transfer pricing, including cost accounting where appropriate, should be made available to the tax administration as part of the transfer pricing documentation and / or in the context of transfer pricing examinations.

55. Where relevant cost accounting information exists and is accessible to tax authorities, its calculation generally involves allocation of overhead or other expenses. Where cost accounting is used to support a transfer pricing policy, tax administrations typically need information on the choice of the allocation methods in order to be able to assess the reasonableness of the allocations made by taxpayers.

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6. See also paragraph 2.26 of the TP Guidelines for the case where there is a chain of distribution through an intermediate company and a resale price method is applied to the sale transaction between the intermediate company and a distributor.

**C - Preliminary conclusion**

56. Access to information is critical to the application of transfer pricing methods and in particular of transactional profit methods. The above-discussed issues should be addressed at a later stage when the OECD revises Chapter V of the TP Guidelines.

#### 4. APPLICATION OF TRANSACTIONAL PROFIT METHODS AND UNIQUE CONTRIBUTIONS

Note: The comments in this note relate to the application of a transactional profit method in the situations where, given the facts and circumstances of the case and in particular the comparability (including functional) analysis of the controlled transaction and the nature and extent of information that is available on possible comparables, a transactional profit method is considered the most reliable method to be used.

##### Introduction

57. Transactional profit methods can be particularly useful in cases involving unique contributions (see discussion of factors affecting the appropriateness and reliability of transfer pricing methods in the note on the status of profit methods). The phrase “unique contributions” is used throughout this document to designate non-benchmarkable functions, assets or risks for which no sufficiently reliable comparable data are available.

58. It would not be desirable to develop a prescriptive list of transactions involving unique contributions that should be remunerated using one or the other transfer pricing methods. Facts and circumstances should determine, given the strengths and weaknesses of all available methods, which method provides the most reliable measure of an arm’s length remuneration in a particular case.

59. A thorough comparability analysis, including a review of possible internal comparables, should be performed for transactions involving unique contributions as is the case for any transaction.

60. The review of the risks assumed by each party to a transaction will generally start with a review of the contractual terms (where contractual arrangements exist in writing). It should then examine whether the risks are real, whether the contractual allocation of risks is arm’s length (see paragraph 1.27 of the TP Guidelines) and whether the conduct of the parties conforms to the terms of the contract (see paragraphs 1.28-1.29 of the TP Guidelines). This Issues note does not address the question of the domestic treatment of risk reward (*e.g.* interest, operational profit or dividend). See paragraph 183 of the Issues note “Application of a transactional profit split: determining the combined profit to be split” for a discussion of the difference between determining the profits attributable to the parties to the transaction and determining how these profits, once attributed, should be taxed domestically.

61. As discussed in the Issues note “Review of transactional profit methods: status as last resort methods”, one of the main criteria leading to the choice of a transfer pricing method is the availability of sufficiently reliable comparables to apply it. That being said, some transactions raise difficult issues in relation to comparability due to:

- The lack of comparables for unique contributions, and
- The lack of reliable financial information on third parties’ unique functions, intangibles ownership and fair value and on their risk-bearing, the identification of which may not be required by accounting principles and financial reporting rules, which can make the reliability of the comparison very uncertain.

62. For example, in situations where both parties to a transaction contribute unique intangibles, reliable independent comparables data to benchmark the appropriate arm's length return of either party may simply not exist. If such unique intangibles are highly valuable, they would materially affect the conditions of the transaction and the lack of comparable data could be problematic.

63. These difficulties should be borne in mind when the use of a transfer pricing method is being considered. In those cases where there are no or insufficiently reliable comparable data to apply a traditional transaction method or a transactional net margin method, the transactional profit split method may be considered. See paragraph 6.26 of the TP Guidelines.

64. When assessing the impact of contributions on the reliability of a transfer pricing method, care needs to be taken to assess their specificities and true value. For instance not all intangibles are unique and highly valuable. The presence of non-unique or low value intangibles should not necessarily mean that the comparability standard could not be met under a traditional transaction method or transactional net margin method.

#### **A- Transactions involving unique contributions and transactional profit split**

##### ***A-1 In what cases involving unique contributions can a transactional profit split be the most reliable method to use?***

65. General considerations about when to use a profit split are found at paragraph 3.5 of the TP Guidelines. As noted above, a transactional profit split method may be found to be the most reliable method in cases where there are no or insufficiently reliable comparable data to apply a traditional transaction method or a transactional net margin method, *e.g.* because both parties to the transaction make unique contributions or because the presence of significant functions, intangibles or risks cannot be ascertained in comparables.

66. A transactional profit split method may also be found to be the most reliable method in cases where valuable contributions are made by both parties to a transaction, because in such a case independent parties at arm's length 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 contributions, reliable comparables information might be insufficient to apply another method.

67. One example would be the case where both parties to a transaction co-develop and co-exploit the same intangible. Another example would be the case where each party to the transaction owns and / or uses a different intangible of significant value. Other examples are found in situations where unrelated parties at arm's length would have entered into joint ventures or partnerships, whether formal or informal, with the profits / revenues / costs to be split between them.

68. In addition it was suggested that a transactional profit split method might be useful as a sanity check in cases where accounting for differences in risk levels and the realisation of risks is difficult. The discussion of sanity checks is found in a separate Issues note, "Use of more than one method".

**A-2      *How to apply a transactional profit split method in cases involving unique contributions***

69. General guidance on the application of a transactional profit split method is discussed in separate Issues notes.<sup>7</sup> Where a transactional profit split method is found to be the most reliable method to be used in a case involving significant unique contributions, use of the method will require a detailed functional analysis of all of the parties involved in the transaction chain to establish the rewards appropriate to each in respect of their functions, taking account of their assets and risks. The use of this method will allow due weight to be given to the rewards due to the developers and owners of the intangibles based on a full understanding and analysis of which of the parties actually bears the risks or carries out the functions. In practice, the use of a transactional profit split method requires sufficient information to be available from both sides of the transaction and good cooperation from the taxpayer and from the foreign related party concerned. Where a taxpayer chooses to use a transactional profit split method, it should be prepared to provide the tax administration with sufficient information on both sides of the transaction, including when the method is reviewed outside the APA context.

70. In the absence of external market data to support the splitting of the combined<sup>8</sup> profit, a variety of approaches to determine a transactional profit split in related party situations have been observed in practice, the most common being:

- A split of the profits according to an indicator that reflects each party's investment in the acquisition or creation and development of the intangible(s) involved in the transaction, *e.g.* capital employed or costs incurred by the parties. Where costs are used they can be discounted to account for any timing differences, capitalised and amortised to create an intangible asset, and are sometimes weighted differently (or discounted at different rates) to account for differences in relative risk, etc.
- Appraisals using valuation techniques not directly linked to capital or costs.
- A subjective analysis, using text or charts to show the relative contributions made by the parties.

71. The objective of applying a transactional profit split method is to seek to achieve the division of profits that independent enterprises would have expected to realise in a comparable situation and the mechanism to split the profit does not need to be a straight forward allocation key. As recognised at paragraph 3.15 of the TP Guidelines, there are a number of approaches for estimating the division of profits based on either projected or actual profits, as may be appropriate, that independent enterprises would have expected, and the contribution and residual analyses described in the TP Guidelines are two of the possible approaches. See separate Issues notes on “How to split the combined profit” and on “Reliability of a residual and a contribution analysis”.

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7. See Issues notes: “Determining the combined profit to be split”; “Reliability of a residual and a contribution analysis”; “How to split the combined profits”.

8. As noted at paragraph 3.5 of the TP Guidelines, the combined profit may be the total profit from the transactions or a residual profit intended to represent the profit that cannot readily be assigned to one of the parties, such as the profit arising from high-value, sometimes unique, intangibles. In addition, as noted in the Issue note on “Determining the combined profit to be split”, references to combined profits should be taken as applying equally to combined losses in appropriate circumstances.

**B - Transactions involving intangibles and the transactional net margin method**

72. Section B.1 below discusses the use of a transactional net margin method in cases where intangibles are involved in the controlled transaction but are not the subject of the transaction (*e.g.* manufacturing and sale of products involving the use of intangibles). Section B.2 discusses the use of a transactional net margin method to assess the arm's length nature of a royalty.

***B-1 In what transactions involving intangibles can a transactional net margin method be the most reliable method to use?***

73. A transactional net margin method is unlikely to be reliable if both parties to a transaction use unique intangibles (see paragraphs 61, 62 and 63 above).

74. 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 and in particular uses all the key intangibles involved in the controlled transaction, while the other party does not make any unique contribution. In such a case, the tested party shall be the less complex one.

75. 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 still be possible to meet the comparability requirements to apply a traditional transaction method or a transactional net margin method because the comparables would be expected to also use a comparable mix of non-unique contributions.

76. In cases where a residual profit split is used (see section A above), a transactional net margin method may be used in a first step to attribute an initial remuneration to benchmarkable functions, before remunerating unique contributions, in cases where a traditional transaction method does not provide for a superior comparability. See discussion of the selection of transfer pricing methods in the Issues note "Review of transactional profit methods: status as last resort methods".

77. Finally, the lack of significant intangibles involved in a particular transaction does not automatically imply that the transactional net margin method is the method to be used. First, because traditional transaction methods (and internal comparables where they exist) should be applied if they are capable of producing a more reliable result. Secondly, because it is possible that a party to a transaction does not use significant intangibles but nevertheless should be entitled to profits that fall outside typical ranges of a transactional net margin method, because for instance of unique contributions other than intangibles, *e.g.* unique functions, tangible assets or risks, which would make the transactional net margin method (as well as traditional transaction methods) inapplicable and could lead to the selection of a profit split.

***B-2 Valuation of intangibles and application of a transactional net margin method: determining or testing a license fee***

78. Existing guidance on the valuation of intangible property is found at Chapter VI of the TP Guidelines and in particular at paragraphs 6.20 to 6.35 (see also AN-15 providing examples of intangible property and uncertain valuation). As noted at paragraph 6.14 of the TP Guidelines, arm's length pricing for intangible property must take into account for the purposes of comparability the perspective of both the transferor of the property and the transferee. From the perspective of the transferor, the arm's length principle would examine the pricing at which a comparable independent enterprise would be willing to transfer the property. From the perspective of the transferee, a comparable independent enterprise may or may not be prepared to pay such a price, depending on the value and usefulness of the intangible property to the transferee in its business.

79. A variety of approaches are observed in practice as discussed below. In some cases, two methods can be combined, *e.g.* to approximate a bargaining range between the licensor and the licensee, or where a secondary method is used as a sanity check to test the outcome of a primary method.

80. In establishing an arm's length price for a sale or license of intangible property, the TP Guidelines note that it is possible to use the comparable uncontrolled price method where the same owner has transferred or licensed comparable intangible property under comparable circumstances to independent enterprises. The amount of consideration charged in comparable transactions between independent enterprises in the same industry can also be a guide, where this information is available, and a range of pricing may be appropriate (see paragraph 6.23 of the TP Guidelines). However, the experience has shown, first, that internal or independent third-party comparable uncontrolled prices are rarely available, and second, that comparisons of royalty rates in an industry sector should not be disconnected from the economic analysis of the controlled transaction under review.

81. The TP Guidelines further note at paragraph 6.23 that if the associated enterprise sub-licenses the property to third parties, it may also be possible to use some form of the resale price method to analyse the terms of the controlled transaction. This however is not the most common situation in practice.

82. Cost-based approaches are sometimes observed, which consist in determining an arm's length return for the licensor's acquisition or development and maintenance costs. Where the return is a net profit margin indicator, such cost-based approach can be seen as an application of the transactional net margin method. Cost-based approaches should however be used with great caution because there is no necessary link between costs and value of an intangible (see paragraph 6.27 of the TP Guidelines). It is possible that high costs are incurred for unsuccessful research and no intangible value. It is also possible that a highly valuable intangible exists without proportional costs being incurred.

83. One possible approach mentioned in the TP Guidelines is to determine the expected benefits from the intangible property *e.g.* through a net present value calculation (see paragraph 6.20 of the TP Guidelines). A profit split method may also be relevant in particular instances as discussed in Section B above (see paragraph 6.26 of the TP Guidelines).

84. Some countries consider that a transactional net margin method whereby the licensee is the tested party, applied in a manner as reliable as possible, may in appropriate circumstances be used alone or in conjunction with any of the other approaches (comparable uncontrolled price method, cost-based approach or profit-based approach) in order to ensure that the remuneration of the licensee after deduction of the license fee remains within an arm's length range. This approach is not mentioned at Chapter VI of the TP Guidelines. Its proponents consider that a measure of the net margin derived by independent parties comparable to the licensee might provide a measure of the level of net margin the licensee would seek to achieve at arm's length, and accordingly an indirect measure of the maximum level to which the license fee may be set from the perspective of the licensee.

85. Some countries are sceptical as to the use of the transactional net margin method alone or in conjunction with another method to set or test the outcome of a license fee (see the note "Use of more than one method" for a discussion of the difference between using a transactional net margin method as a sanity check or in conjunction with another method). In particular, some countries note that where a transactional net margin method is used, to test the outcome of a transaction involving a licensing arrangement, rather than to set the licence fee, they would not accept that it leads to changing the license fee every year, possibly retroactively, based on the performance of the licensee, because they would not regard this as usual business practice between independent parties at arm's length.

86. Alternatively, a transactional net margin method could be useful as a sanity check to test the outcome of a primary method used to value the license fee. As discussed in the Issues note, “Use of more than one method”, the purpose of a sanity check is only to identify unusual outcomes that would suggest the need to further review the choice and application of the primary method, but the latter should not be rejected just because it produces an unusual or undesired outcome.

87. Where a transactional net margin method is used as a sanity check to test the outcome of a primary method used to value a license fee, it is important to apply the transactional net margin method only to the taxpayer’s transactions that benefit from the license. For example, assume a taxpayer manufactures and distributes a Product A for which it owns all the intangible property rights, and distributes a Product B for which has concluded a license agreement and pays a license fee. Assume Product A and Product B are two independent business lines. The license fee paid by the taxpayer for Product B might possibly be tested by examining the net margin earned by the taxpayer on the distribution of Product B after deduction of the license fee, compared to the net profit margin earned by uncontrolled comparables. However, the net margin earned by the taxpayer in the manufacturing and distribution of Product A should not be taken into account in the calculation unless the profitability of each of the business lines is linked to each other.

88. One advantage of using a transactional net margin method as a sanity check is that it would make it possible to ensure that the license fee takes account of the economic circumstances of the licensee. In effect, a uniform royalty rate applied to all licensed affiliates throughout an MNE group, that may be based for instance on a review of industry averages or on the determination of a return on investment for the licensor, is not necessarily arm’s length if there are material differences between the economic situations of the licensees.

89. In addition, it should be noted that the functional analysis of a licensee may be different from the functional analysis of a non-licensed distributor or manufacturer because the licensee holds a contractual right over the intangible. Whether this difference materially affects the comparison depends on the value of the license right and on the extent to which the licensee actually exploits it, *e.g.* whether it has and actually exercises more autonomy in the development of products or of marketing campaigns than a non-licensed manufacturer or non-licensed distributor who would simply manufacture according to specifications or buy-and-sell products. Where appropriate, these differences need to be taken into account in the comparability analysis.

## 5. APPLICATION OF THE TRANSACTIONAL NET MARGIN METHOD: STANDARD OF COMPARABILITY

Note: The comments in this note 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 controlled transaction and the nature and extent of information that is available on possible comparables, a transactional net margin method is considered the most reliable method to be used.

### Introduction

90. Existing guidance on the comparability standard to be applied to the transactional net margin method is found at Section B (ii) (c) (1) (paragraphs 3.34 to 3.40) of Chapter III of the TP Guidelines. The question was raised of whether a different comparability standard could / should be applied to the transactional net margin method from the standard applied to other methods (in particular traditional transaction methods). Business and country comments were invited in particular on the following aspects:

- Paragraph 3.34 indicates that “[p]rices are likely to be affected by differences in products, and gross margins are likely to be affected by differences in functions, but operating profits 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.” To what extent can a lower comparability standard be applied in a transactional net margin method than in a traditional method and for what reason(s)?
- Experience shows that practitioners often apply the transactional net margin method by comparing the net margin earned by the taxpayer in a controlled transaction or set of controlled transactions with the company-wide net margin reported by third parties. In some other cases, it is the taxpayer’s net margin that is determined on a company-wide aggregated level. To what extent do you consider the transactional net margin method can validly be applied using company-wide aggregated data (either on third party “comparables” or on the taxpayer’s net margin)? To what extent can a lower standard for aggregating transactions be applied in the transactional net margin method than in a traditional method and for what reason(s)?

91. This note summarises the outcome of the discussion by the Working Party of these issues and of comments received.

### A - Comparability analyses and TNMM: general considerations

92. Comparability is at the heart of all transfer pricing analyses. The foundation for comparability analyses is found at paragraph 1 of Article 9 of the OECD Model Tax Convention which introduces the need for a comparison between conditions made or imposed between associated enterprises and those which would be made between independent enterprises, as well as for a calculation of profits that would have accrued to the enterprise at arm’s length. The reasoning in this paragraph is a two-stage one:

- First, a comparison of “conditions” made or imposed between associated enterprises with those which would be made between independent enterprises is necessary to determine *whether* a transfer pricing adjustment may be performed,
- Secondly, when special conditions that have been made or imposed between the associated enterprises have been identified, a *calculation* of the transfer pricing adjustment is made, by recalculating the profits which would have accrued to the enterprise in the absence of such conditions or adjusting the conditions to an arm’s length level.

93. Given the critical importance of comparability, the Working Party is of the view that a sufficiently reliable comparability analysis must be performed in all cases in order to select and apply a transfer pricing method and that the process for selecting and applying a transactional net margin method should not be less rigorous than for other methods. In the Working Party’s view, this means that a sufficiently reliable analysis, including the review of the conditions of the controlled transaction, the examination of the five comparability factors identified in the TP Guidelines and of the conditions for using data on aggregated transactions, must be performed in order to apply any transfer pricing method, including the transactional net margin method. In particular, it is recommended that the typical process for identifying comparable transactions (including internal comparables where available) and using data so obtained which is described in the discussion draft on comparability issues<sup>9</sup> 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.

94. That being said, the discussion draft on comparability issues recognises that in practice the level of information available on the factors affecting external comparable transactions is often limited. Finding a reasonable solution to all transfer pricing cases requires flexibility and the exercise of good judgement. Paragraph 5 of the note “Examining the five comparability factors”<sup>10</sup> reads as follows:

“The Working Party discussed whether a less detailed analysis of external comparables than of a taxpayer’s own transactions would be acceptable because of the practical difficulty involved. It concluded that as a matter of principle a less rigorous analysis of third party transactions would not be acceptable, but that in practice the detail of information needed on each of the five comparability factors affecting the transactions of a third party needs to be assessed on a case by case basis (as in fact is already suggested by the existing language in paragraph 1.18 of the TP Guidelines).”

95. This conclusion is valid for all transfer pricing methods including the transactional net margin method. In effect the OECD considers that it is important for its guidance to be both theoretically sound and practically workable.

96. In addition, the transactional net margin method is less sensitive to some transactional or functional differences than traditional transaction methods (see section B below). This is already acknowledged at paragraph 3.27 of the TP Guidelines and was emphasised by several business commentators in response to the OECD questionnaire on profit methods. Thus, while the comparability analysis leading to the selection and application of the transactional net margin method should be as reliable as with any other method (in the sense that all of the comparability factors and the conditions for aggregation should be considered), the outcome of said analysis might reflect that the application of the

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9. Discussion Draft on Comparability released on 10 May 2006, page 45, [http://www.oecd.org/document/12/0,3343,en\\_2649\\_33753\\_36651660\\_1\\_1\\_1\\_1,00.html](http://www.oecd.org/document/12/0,3343,en_2649_33753_36651660_1_1_1_1,00.html).

10. Discussion Draft on Comparability released on 10 May 2006, page 36, [http://www.oecd.org/document/12/0,3343,en\\_2649\\_33753\\_36651660\\_1\\_1\\_1\\_1,00.html](http://www.oecd.org/document/12/0,3343,en_2649_33753_36651660_1_1_1_1,00.html).

transactional net margin method is less materially affected than other methods by some of the differences identified between the controlled and uncontrolled transactions being compared. As a consequence, there will be cases in practice where the same uncontrolled transaction requires fewer comparability adjustments (and is therefore regarded as a better comparable) when used with a transactional net margin method than with a traditional transaction method. There will also be cases of uncontrolled transactions that would not be regarded as satisfactory comparables when applying a traditional transaction method due to transactional or functional differences, but could be satisfactory comparables for the transactional net margin method because the latter would be less affected by such differences. Limitations that may exist on the availability of sufficiently reliable comparables to apply a traditional transaction method, and the existence of transactional or functional differences that are eliminated in a net margin analysis, are among the criteria that may influence the choice of the transfer pricing method and in appropriate cases lead to the selection of a transactional net margin method in particular where better comparable information is available to apply the latter.<sup>11</sup> This means that in some circumstances the transactional net margin method might be selected because it provides better comparables than other methods in the circumstances of the case.

## **B - Comparability factors and the transactional net margin method**

97. Section C (i) (b) of Chapter I of the TP Guidelines and the 2006 discussion draft on comparability contain a detailed discussion of the five comparability factors.<sup>12</sup> Those comments apply to the transactional net margin method as well as to other methods and do not need to be repeated here. The comments below are limited to a few specific points in relation to the transactional net margin method.

98. As noted at paragraph 1.15 of the TP Guidelines,

“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.”

99. One strength of the transactional net margin method is that some differences in comparability factors that would materially affect the outcome of a traditional transactional method might not affect or might less materially affect the outcome of the transactional net margin method depending on the circumstances of the case.

100. For example, some differences in accounting classification that would affect a gross margin analysis might disappear at the net margin level. This is the case for instance for adjustments for accounting reclassifications from cost of goods sold to operating expenses.

101. It is also recognised that the net margin 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.

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11. See the note “Review of transactional profit methods: status as last resort” for a discussion of the factors influencing the choice of the transfer pricing method.

12. Discussion Draft on Comparability released on 10 May 2006, pages 35-44, [http://www.oecd.org/document/12/0,3343,en\\_2649\\_33753\\_36651660\\_1\\_1\\_1\\_1,00.html](http://www.oecd.org/document/12/0,3343,en_2649_33753_36651660_1_1_1_1,00.html).

**Illustration 1:**

*Effect of a difference in the intensity 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 choice of the transfer pricing method, on the choice 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 intensity 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>
Sales of product (for illustration purposes, assume both sell the same volume of the same product on the same market at the same price)	1,000	1,000
Purchase price from manufacturer taking account of the significance of the marketing function in accordance to the functional analysis	600	480 (*)
Gross margin	400 (40%)	520 (52%)
Marketing expenses	50	150
Other expenses (overheads)	300	300
Net profit margin	50 (5%)	70 (7%)

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

102. Under Illustration 1, if a taxpayer is operating with a related party manufacturer as in case 2 while the third party “comparables” are operating as in case 1, and assuming that the difference in the intensity 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 intensity 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 choice of the transfer pricing method, on the choice 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> <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>	<b>Case 2</b> <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 (for illustration purposes, assume both sell the same volume of the same product on the same market at the same price)	1,000	1,000
Purchase price from manufacturer taking account of the obsolescence risk in accordance to the functional analysis	700	640 (*)
Gross margin	300 (30%)	360 (36%)
Loss on obsolete inventory	0	50
Other expenses (overheads)	250	250
Net profit margin	50 (5%)	60 (6%)

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

103. 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).

104. 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, intensity 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 margin 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 choice of the transfer pricing method, on the choice 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.*

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

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

105. 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 margins can be more sensitive than gross mark-up 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.

106. In using comparables' net margins, care needs to be taken to exclude revenues and costs not connected to the revenues and expenses of the comparable transactions. For example, in a distribution case involving a comparison of net margins earned by a taxpayer in controlled transactions and by third parties in uncontrolled transactions, the net margin of both the taxpayer and the third party comparables might need to be corrected in order to exclude any items related to another distribution activity unless that other distribution activity can be aggregated with the one under review in accordance to the aggregation principles of paragraph 1.42 of the TP Guidelines.

107. Where there are differences in comparability factors that materially affect the outcome of a traditional transactional method, it might be possible to make comparability adjustments to eliminate the effect of such differences.<sup>13</sup> Net profit margin indicators can be adjusted for a variety of differences. The most common adjustments are adjustments for assets and/or risks such as:

- For accounting differences, *e.g.* for depreciation in property, plant, equipment;
- For working capital: inventory level, payables and / or receivables.<sup>14</sup>

## **C - Aggregation, segmentation of transactions with the transactional net margin method Portfolio approaches.**

### ***C.1 Aggregation of the taxpayer's transactions***

108. General guidance on the aggregation of a taxpayer's transactions is found at paragraph 1.42 of the TP Guidelines. In addition, paragraph 3.42 of the TP Guidelines provides guidance on the use of taxpayer's or third party aggregated transactions as follows:

“An analysis under the transactional net margin method should consider only the profits of the associated enterprise that are attributable to particular controlled transactions. 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. 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 profit margins 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.”

109. This guidance still provides a reasonable and theoretically sound framework for addressing the issues that arise from the use of broadly aggregated or company-wide data.

110. Reaching the proper level of aggregation or segmentation of a taxpayer's activities is essential to ensure that the taxpayer's profit in certain lines of aggregated transactions can be compared in a reasonably reliable manner with the profit in comparable uncontrolled transactions. In general it is reasonable to expect an examination of a taxpayer's net margin on a transactional or appropriately segmented rather than company-wide basis. Owing to the lack of detailed publicly available third party information in many

13. See discussion of comparability adjustments in the Discussion Draft on Comparability released on 10 May 2006, pages 49-58, [http://www.oecd.org/document/12/0,3343,en\\_2649\\_33753\\_36651660\\_1\\_1\\_1\\_1,00.html](http://www.oecd.org/document/12/0,3343,en_2649_33753_36651660_1_1_1_1,00.html)

14. See example of a working capital adjustment in the Discussion Draft on Comparability released on 10 May 2006, pages 56-58, [http://www.oecd.org/document/12/0,3343,en\\_2649\\_33753\\_36651660\\_1\\_1\\_1\\_1,00.html](http://www.oecd.org/document/12/0,3343,en_2649_33753_36651660_1_1_1_1,00.html)

instances, the segmentation of the tested party's activities and comparison with comparable third parties is often less problematic than the segmentation of a third party's results, subject to the taxpayer's financial accounting system being able to track profitability on an appropriately segmented basis. As noted in the discussion draft on comparability issues, there may be cases where aggregated third party transactions might provide a valid comparable for one particular, non-aggregated transaction of the taxpayer.<sup>15</sup>

## ***C.2 Acceptability of a portfolio approach***

111. A portfolio approach is a business strategy consisting for a taxpayer in bundling certain transactions for the purpose of determining or testing its transfer prices. For instance, some products may be marketed with a low profit or even at a loss, because they create a demand for other products of the same firm that are then sold 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.

112. Portfolio approaches are not specific to the transactional net margin method. They 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 1.31 - 1.35 of the TP Guidelines). The enterprise may accept that there will be some products that do well and others that do not, but the overall outcome remains acceptable. In some cases, the poorly performing products may have overall benefits in supporting or complementing other, more profitable products or a product range. This can be acceptable if the intention of the taxpayer to adopt such a portfolio approach is documented and makes economic sense. However, these considerations will not explain continued overall losses or poor performance over time.

113. Moreover, in order to be acceptable, portfolio approaches must be reasonably targeted as they should not be used as a pretext to apply the transactional net margin method at the taxpayer's company-wide level in those cases where different transactions have different economic logics and should be segmented (see paragraph 3.42 of the TP Guidelines and discussion under Section C.1 above).

## ***C.3 Segmentation of third party data – use of third party company-wide data***

114. The discussion draft on comparability issues contains extensive discussion of segmentation of third party data.<sup>16</sup> While this is not an issue specific to the transactional net margin method, it is in practice more acute due to the heavy reliance on external comparables when applying this method.

115. The problem arises because there are often insufficient public data to allow for third party margins to be determined on specific transactions or a small group of transactions. This is why there needs to be sufficient comparability between the economically significant functions of the tested party and of the third party comparables. Given that often the only data available for the third parties are company-wide aggregated 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 related party dealings in order to allow the former to be used to determine an arm's length outcome for the latter.

116. The appropriate level of segmentation is a matter of judgement with the overall objective being to determine that level of segmentation that provides the greatest comparability to the controlled transaction, based on the facts and circumstances of the particular case.

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15. Discussion Draft on Comparability released on 10 May 2006, page 64 paragraph 2, [http://www.oecd.org/document/12/0,3343,en\\_2649\\_33753\\_36651660\\_1\\_1\\_1\\_1,00.html](http://www.oecd.org/document/12/0,3343,en_2649_33753_36651660_1_1_1_1,00.html).

16. Discussion Draft on Comparability released on 10 May 2006, pages 64-68, [http://www.oecd.org/document/12/0,3343,en\\_2649\\_33753\\_36651660\\_1\\_1\\_1\\_1,00.html](http://www.oecd.org/document/12/0,3343,en_2649_33753_36651660_1_1_1_1,00.html).

117. In case it is impossible in practice to achieve the transactional level set out as the ideal by the TP Guidelines, it is still important to achieve the highest level of comparability possible through making suitable adjustments based on the evidence that is available.

#### **D - Preliminary conclusion**

118. There is a need to reaffirm the importance of a sufficiently reliable comparability analysis to be performed in order to select and apply a transactional net margin method as is the case with any transfer pricing method. The language at Section B (ii) (c) (1) of Chapter III of the TP Guidelines could be supplemented to that effect. Section A of this note could provide a basis for this amendment.

119. The guidance at Section B (ii) (c) (1) of Chapter III of the TP Guidelines could also be supplemented to address a few specific comparability issues arising with the transactional net margin method as described at section B above.

120. In addition, strong concerns have been expressed by countries in relation to aggregation / segmentation of taxpayer and comparable transactions and use of company-wide information. While these issues are not specific to the transactional net margin method, they are in practice more acute due to the heavy reliance on external comparables when applying this method. Accordingly, it might be useful to complement the existing language at paragraph 3.42, building on the outcome of the discussion of Section C above and of the discussion of the use of non-segmented third party data in the context of the review of comparability.

## 6. APPLICATION OF THE TRANSACTIONAL NET MARGIN METHOD: SELECTION AND DETERMINATION OF THE NET PROFIT MARGIN INDICATOR

Note: The comments in this note 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 controlled transaction and the nature and extent of information that is available on possible comparables, a transactional net margin method is considered the most reliable method to be used.

### Introduction

121. Paragraph 3.26 of the TP Guidelines defines the transactional net margin as follows:

“The transactional net margin method examines the net profit margin relative to an appropriate base (*e.g.* costs, sales, assets) that a taxpayer realizes from a controlled transaction (or transactions that are appropriate to aggregate under the principles of Chapter I). Thus, a transactional net margin method operates in a manner similar to the cost plus and resale price methods. [...]”

122. There is however no definition of the net profit margin in the TP Guidelines. Paragraph 3.27 contains a reference to “return on assets, operating income to sales, and possibly other measures of net profit”. Paragraph 3.41 indicates that:

“In applying the transactional net margin method, various considerations should influence the choice of margin used. For example, these considerations would include how well the value of assets employed in the calculations is measured (*e.g.* to what extent there is intangible property the value of which is not captured on the books of the enterprise), and the factors affecting whether specific costs should be passed through, marked up, or excluded entirely from the calculation.”

Besides that, the TP Guidelines do not contain much guidance on when costs, sales, assets or any other factor would be the appropriate base.

123. Business and country comments were invited on how to select a net margin indicator to apply the transactional net margin, in particular:

- What is a "net" margin: what are the expenses that should be treated as above or below the line? Does the response to this question differ depending on the functional analysis of the parties, *e.g.* on which party is responsible for what costs?
- In what cases should the net margin be weighted against costs, sales, assets, or another base?
- Where the indicator is the net margin to costs, what costs should be included in the base? In what cases would a net margin to costs be more reliable or more appropriate than a gross cost plus indicator and why?
- How to ensure that the costs and expenses deducted from the net margin calculation are those attributable to the transaction under review?

- In what cases would a net margin to sales be more reliable or more appropriate than a gross resale minus indicator and why?
- Where the indicator is a net margin to assets, how should tangible and intangible assets be valued (market value or book value)?
- What other net margin indicators do you consider as relevant and in what cases?

124. The note below is intended to summarise the outcome of the Working Party's discussion of the comments received.

#### **A - General comments**

125. Business commentators who responded to the questionnaire on profit methods consider that the choice of the net profit margin indicator should depend on the facts and circumstances of the case. The Working Party agrees that it would not be appropriate to draw a prescriptive list of situations where the use of one or another indicator would be required. The relative merits of the different measures of net profit margin vary depending upon the circumstances of the case. The two main factors influencing the choice of the appropriate net profit margin indicator should be:

- Its relevance to the circumstances of the case and in particular to the industry and comparability analyses, including the functional analysis and value drivers of the transaction under review.
- The availability of information on uncontrolled transactions to enable a meaningful and reasonably reliable comparison on the basis of that particular indicator. The same net profit margin indicator must be measured for the tested party and the uncontrolled comparable(s) to compare like with like and sufficient information on the uncontrolled comparable(s) must be available to give reasonable comfort as to the reliability of that measure.

126. When applying a transactional net margin method, taxpayers or tax administrations can be expected to show that the indicator they select is appropriate to the circumstances of the case and enables a reasonably reliable measure at the level of both the taxpayer's controlled transaction and the uncontrolled transactions used as comparables.

#### **B - Determining the net profit margin**

127. As a matter of principle, only those items that directly or indirectly relate to the controlled transaction at hand and are of an operating nature should influence the determination of the net profit margin for the application of the transactional net margin method. Specific consequences of these two conditions are discussed below.

##### *Exclusion of costs and revenues that are not related to the controlled transaction under review*

128. As noted at paragraph 3.42 of the TP Guidelines,

“An analysis under the transactional net margin method should consider only the profits of the associated enterprise that are attributable to particular controlled transactions. 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.”

129. As a consequence, an appropriate level of segmentation of the taxpayer's financial data is needed when determining or testing the net profit margin it earns from a controlled transaction (or from transactions that are appropriately aggregated according to the guidance at paragraph 1.42 of the TP Guidelines – subject to this guidance being updated as a result of the review of comparability).

*Exclusion of non-operating items*

130. Income taxes should be excluded from the determination of the net profit margin indicator because they are not of an operating nature.

131. Exceptional and extraordinary items of a non-recurring nature should generally 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 (see for instance discussion of termination costs below). Even where exceptional and extraordinary items are not taken into account in the determination of the net margin, it will generally 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).

*Financial items*

132. Interest income and expenses other than those on trade receivables and payables should generally be excluded when applying the transactional net margin method to non-financial transactions, where they relate to the capital structure of the business and not to the operating return from the business activities. Earnings before Interest and Tax (EBIT) is therefore one of the most commonly used indicators for non-financial transactions.

133. It was suggested that in some cases it might be appropriate to include interest in respect of short-term working capital within the net profit margin calculation, *e.g.* if credit terms can affect sales prices or operating margins. 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. The Working Party agrees that in those cases where there is a correlation between the credit terms and the sales prices, it could be appropriate to reflect interest income within the calculation of the net margin and / or to proceed with a working capital adjustment (see discussion of comparability adjustments including working capital adjustments in the Discussion Draft on Comparability released on 10 May 2006, pp. 49-58).<sup>17</sup>

134. Whether foreign exchange gains and losses should be included or excluded depends on whether they are of a trading nature (*e.g.* exchange gain or loss on a trade receivable or payable that was not hedged) and on whether or not the tested party is responsible for them. 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 margin indicator or separately).

135. For financial activities where interest is trade interest, as well as in other situations where the capital structure may heavily influence the prices, it will generally be appropriate to consider the effect of interest when determining the net profit margin.

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17. [http://www.oecd.org/document/12/0,3343,en\\_2649\\_33753\\_36651660\\_1\\_1\\_1\\_1,00.html](http://www.oecd.org/document/12/0,3343,en_2649_33753_36651660_1_1_1_1,00.html).

*Depreciation and amortisation*

136. Whether or not to include depreciation and amortisation costs depends on the circumstances of the case. Depreciation and amortisation charges are very susceptible to differences in accounting treatment and in particular in the deemed accounting life of the asset. This may materially distort the comparison between the tested party's results and those of third party comparables in asset-intensive industries and depending on the circumstances of the case a more reliable comparison might be achieved using a net profit margin ratio that does not include depreciation and amortisation.

137. It was for instance suggested that when companies have significant acquisitions that result in the revaluation of both tangible and intangible assets to "market" value, Earnings Before Interest, Tax, Depreciation and Amortisation (EBITDA) may be the most reliable measure, and that it may be appropriate to exclude book intangible assets from the analysis, as such book intangible assets are typically the result of acquisitions, and do not include internally developed intangibles.

138. Depreciation and amortisation can pose difficult comparability issues, for instance if two parties own and / or use comparable intangibles, but one has acquired them and amortised them over time, while the other has developed them and expensed them upfront.

139. For this reason, some commentators suggest that depreciation and amortisation ought to be excluded from the determination of the net profit margin indicator. On the other hand, in asset-intensive industries where assets are key value-drivers, excluding depreciation and amortisation might not lead to a meaningful outcome, and depreciation and amortisation would not be excluded if it can be reasonably assumed that they do not create material comparability issues. Where uncertainties of that type are material, the third party comparable concerned might have to be rejected. Where no or insufficient satisfactory comparables are available to apply the considered net margin indicator, another net margin indicator that is less sensitive to depreciation and amortisation costs might need to be considered.

*Start-up costs and termination costs*

140. A further question is whether start-up costs and termination costs should be included in the determination of the net profit margin indicator. The response depends on the facts and circumstances of the case and on whether in comparable circumstances, independent parties at arm's length 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 to the customer / 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 margin indicator of the party performing the functions. One factor that is likely to affect the choice is whether the activity is created by the taxpayer for the exclusive benefit of one related party, or whether the taxpayer also has other (related or unrelated) customers for this activity (see also existing guidance on business strategies at paragraphs 1.31-1.35 of the TP Guidelines).

*Pension costs and stock options*

141. Pension costs and stock options can raise difficult issues in particular with respect to comparability where the accounting treatment of those items by third party comparables is unclear or does not allow reliable measurement or adjustment. Where employee stock options are elements of remuneration, there is no economic reason for treating them differently from other elements of

remuneration.<sup>18</sup> Moreover, where personnel costs are key value-drivers, they should be included in the net profit margin indicator.

142. However, this can pose difficult comparability issues in those cases where there are material uncertainties as to whether or not third party employees involved in the performance of the comparable uncontrolled transactions benefit from stock options, or if they are known to benefit from a material amount of stock options which cannot be valued in a reasonably accurate manner. Where uncertainties of that type are material, the third party comparable concerned might have to be rejected. Where no or insufficient satisfactory comparables are available to apply the considered net margin indicator, another net margin indicator that is less sensitive to remuneration costs might need to be considered.

## C - Weighting the net margin

### C.1 Choosing the denominator

143. The TP Guidelines indicate that in applying the transactional net margin method, the net profit margin should be determined 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). The following considerations may assist in choosing the appropriate base. In some cases, as discussed in the Issue note on the “Use of more than one method”, a transactional net margin method might be used with two different financial indicia to which the guidance below should equally apply.

#### *A denominator that is consistent with the comparability (including functional) analysis*

144. The choice of the denominator should be consistent with the comparability (including functional) analysis, and in particular it should reflect the allocation of risks among the parties (provided said allocation of risks is arm’s length, see paragraph 1.27 of the TP Guidelines). For instance, capital-intensive activities such as certain manufacturing activities may involve significant risk due to the significance of the investments, 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 margin 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 depending on what party to the

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18. See the Study “Employee stock option plans: impact on transfer pricing” that was published in September 2004 in the OECD Tax Policy Studies series under the responsibility of the Secretary-General, <http://www.oecd.org/dataoecd/35/37/33700408.pdf>. The analysis in this study starts with the premise that the granting of stock options is an element of remuneration just like performance-related bonuses or benefits in kind, even when stock options are issued by an entity that is distinct from the employer. The introduction notes that there might be exceptional cases where this premise would not work, but that such cases are not discussed in the Study. Section G of the Study tentatively concludes that:

“The existence of an employee stock option plan, and its accounting treatment, can influence transfer pricing of other transactions when such pricing is sensitive to the employee remuneration of one of the parties to the transaction and the stock options are material. Accounting standards vary among countries and currently not all countries regard stock options as entailing an expense to the profit and loss accounts of the company that issues them. When conducting comparability analysis it is important to ensure consistency in the cost basis of both the tested entity and the potential comparable, and it may be necessary to make adjustments to the accounts of the either or both entities. Such adjustments, where decided, may pose significant practical difficulties however, notably the difficulty of gaining access to information about the value of the options granted to employees or categories of employees and determining the period to which the adjustments relate. When, in material cases, it is not possible to make satisfactory adjustments, another transfer pricing method that is less sensitive to the employee remuneration may be considered, either in the first instance or as a consistency test.”

controlled transaction bears that risk, as well as for different levels of risk that may be found in the taxpayer's controlled transaction and in comparables.

145. A concern was raised that in practice the transactional net margin method is often used by taxpayers or tax administrations in a way that sets a net remuneration minimum or maximum threshold regardless of the specific individual circumstances of the enterprise. This issue should be addressed in light of the discussion of extreme results and of loss-making comparables in the comparability Discussion Draft released in May 2006 (see pages 70 and 72-74).<sup>19</sup>

*A denominator that is focussed on the main value-driver for the particular transaction*

146. The appropriate base should be focussed on the main value driver(s) of the transaction under review. Typically, and subject to a review of the facts and circumstances of the case and to the comments under Sections C.2, C.3 and C.4 below, 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, operating assets may be an appropriate base for capital-intensive activities such as certain manufacturing / utilities. Other bases can also be appropriate depending on the circumstances of the case (see Section D below).

*A denominator that is reasonably independent from transfer pricing formulation*

147. A basic principle is that the net profit margin should be weighted against an appropriate base which is reasonably independent from transfer pricing formulation, *i.e.* the denominator should not be the transfer price of the controlled transaction under review, otherwise there would be no objective starting point. For instance, when analysing a transaction consisting in the purchase of goods by a distributor from a related party for resale to unrelated customers, one could not weight the net margin 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 a related party, one could not weight the net margin 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 related party costs that are not the object of the testing (such as head office charges, rental fees or royalties paid to a related party), caution should be exercised to ensure that said related party costs do not materially distort the analysis.

*A denominator that can be reasonably reliably measured and compared*

148. The appropriate base should be one that is capable of being measured in a reasonably reliable and consistent manner at the level of the taxpayer's controlled transactions. In particular, the taxpayer's allocation of indirect expenses to the transaction under review should be reasonable and consistent over time.

149. In addition, the appropriate base should be one that is capable of being measured in a reasonably reliable and consistent manner at the level of the comparable uncontrolled transactions. This in practice limits the ability to use exotic indicators for which there is not sufficient public information. This also raises measurement issues in cases where the net profit margin is weighted to assets, as discussed in Section C.4 below.

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19. [http://www.oecd.org/document/12/0,3343,en\\_2649\\_33753\\_36651660\\_1\\_1\\_1\\_1,00.html](http://www.oecd.org/document/12/0,3343,en_2649_33753_36651660_1_1_1_1,00.html).

## ***C.2 Cases where the net profit margin is weighted to sales***

150. In case the net profit margin indicator is weighted against sales, the sales figure should be the sales related to the transaction under review (or transactions aggregated in accordance to the principle at paragraph 1.42 of the TP Guidelines as may be updated further to the review of comparability and discussion of portfolio approaches in the note “Application of the transactional net margin method: standard of comparability”, Section C.2) and for which the net profit margin indicator was measured. In particular, sales revenue that is derived from uncontrolled activities (purchase from unrelated parties, sales to unrelated parties) should not be included in the determination or testing of the remuneration for controlled activities, unless the controlled and uncontrolled activities 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 unrelated end-user customers where they are closely linked to controlled purchase transactions by the distributor for resale to the same unrelated end-user customers.

151. One question that arises in practice 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.

## ***C.3 Cases where the net profit is weighted to costs: what costs should be included in the denominator?***

152. The choice of a particular transfer pricing method and financial indicator is aimed at providing a reasonable approximation of the conditions that would have been made between independents at arm's length in comparable circumstances and should not be used in a formulaic manner. In particular, cost-based methods (cost plus and cost-based TNMM) 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 as discussed below.

### *Costs that relate to the controlled transaction under review*

153. Where the net profit margin indicator is weighted against costs, only those costs that directly or indirectly relate to the controlled transaction at hand 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. This is an issue similar to the one discussed at Section B above.

154. Moreover, in most cases only those costs which are of an operating nature should be included in the denominator. The discussion of exceptional or extraordinary items, of financial items, of depreciation and amortisation and of start-up and termination costs at Section B above also applies to costs as denominator.

155. In practice, in applying the 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.

*Total costs or value-added costs only?*

156. With respect to the determination of an arm's length cost basis, the question arises 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.<sup>20</sup> Paragraph 3.41 of the TP Guidelines notes that:

“In applying the transactional net margin method, various considerations should influence the choice of margin used. For example, these considerations would include [...] the factors affecting whether specific costs should be passed through, marked up, or excluded entirely from the calculation.”

157. The TP Guidelines do not provide specific guidance on what costs should be passed through or marked up. For instance, there are examples of taxpayers treating “internal” costs such as labour costs and depreciation as “value-added costs” while “external costs” such as purchases of raw materials, of components or services from third parties are treated as “pass-through costs”. In doing so, some taxpayers have argued that “external costs” already include a profit element charged by the external provider. This raises two main questions as discussed below.

158. The first question is the extent to which it is consistent with the arm's length principle to treat costs as pass-through costs, *i.e.* to what extent would an independent party at arm's length accept not to be remunerated on part of the expenses it incurs. The response should not be based on a mere classification of costs as “internal” or “external” costs, but rather on a thorough comparability (including functional) analysis, and in particular on a determination of the value added by the tested party in relation to those costs. For instance, depending on the case at hand, the value of manufactured goods may or may not be an indicator of the value added by a manufacturer, and accordingly inventories may or may not be treated as pass-through costs at arm's length.

159. 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 margin indicator, comparable costs should also be excluded from the denominator of the comparable net profit margin indicator. However, while the information on breakdown of the cost of the tested party is generally available in practice, that of a comparable party is usually difficult to obtain. Therefore it can be quite difficult to exclude “pass-through costs” from the costs of a comparable party. In practice the net profit margin rate on a base that is limited to “value-added costs” is expected to be higher than on a fully loaded base.

*Actual costs, standard costs, budgeted costs*

160. Another issue relates to the question of whether actual costs, standard costs determined by the management of the company based on standard capacity utilisation, or budgeted costs based on the foreseeable activity, should be used in the application of the transfer pricing method. Using actual costs may raise an issue because the tested party may have no incentive to carefully monitor the costs. In third party arrangements it is not rare that a cost savings objective is factored into the remuneration method. It can also happen in unrelated party manufacturing arrangements 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 at arm's length between independent parties, similar mechanisms could be taken into account in the application of the cost-based TNMM. See paragraph 2.45 of the TP Guidelines for a discussion of the same issue in relation to the cost plus method.

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20. A similar issue may arise in relation to “pass-through sales”.

*The Berry ratio*<sup>21</sup>

161. “Berry ratios” are defined as ratios of gross margin to operating expenses. Interest and extraneous income are generally excluded from the gross margin 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 (see Section C.4 below). Concerns have been expressed that Berry ratios are sometimes misused in cases where they are not appropriate, in a formulaic manner, without the caution that is necessary to the selection and determination of any transfer pricing method and financial indicator.

162. The Working Party’s view is that the arm’s length remuneration of selling activities (whether buy-and-sell activities, commissionnaires or sales agents) should generally be based on a sales-related indicator, unless in comparable circumstances independent parties at arm’s length would agree otherwise. A combination of a cost-based indicator (*e.g.* Berry ratio) and of a sales-based indicator might also be acceptable in appropriate circumstances, for instance where the sales operation incurs significant promotional expenditure as a service performed for the principal in addition to its selling activities (see paragraph 2.24 of the TP Guidelines in relation to the resale price method).

163. On the other hand, Berry ratios can be useful to test the remuneration of intermediaries or service providers. In particular, subject to the comments below, Berry ratios can prove useful when applied to intermediary activities where a taxpayer purchases goods from a related party and on-sells them to other related parties. 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 related party costs such as head office charges, rental fees or royalties paid to a related party (see paragraph 147 above), so that a Berry ratio may be an appropriate indicator, subject to the comments below.

164. The choice of the appropriate financial indicator depends on the facts and circumstances of the case and in particular on the comparability analysis and on the availability of reliable information on comparables, see paragraph 125 above. In addition, in order for a Berry ratio to be appropriate to test the remuneration of an intermediary or service provider, it is necessary that:

- (i) The intermediary or service provider perform functions (taking account of assets used and risks assumed), the value of which is proportional to the extent of its activities performed as reflected in its operating expenses,
- (ii) It perform functions (taking account of assets used and risks assumed) the value of which is not materially affected by the value of the products distributed and
- (iii) It not perform any other significant function (*e.g.* manufacturing function) that should be remunerated using another method or financial indicator.

165. 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 above in relation to “pass-through costs” equally arise in the application of Berry ratios.

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21. See “Berry ratios: Their Use and Misuse” by Charles H. Berry, *Journal of Global Transfer Pricing*, April-May 1999, reprinted by CCH Inc.

#### C.4 *Cases where the indicator is a net profit to assets*

166. According to one commentator, rates of return on assets (or on capital<sup>22</sup>) are “the more general measure of economic performance and conceptually allow for comparisons across a more diverse set of industries / economic activities than profit margin measures.” Returns on assets (or on capital) can be appropriate in cases where assets (rather than costs or sales) are a reasonable indicator of the value added by the tested party, *e.g.* in certain asset-intensive manufacturing activities.

*What assets should be included in the denominator?*

167. Where the indicator is a net profit weighted to assets, operating assets only should be used, excluding investments and cash balances. 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).

168. One commentator suggested that for practical reasons, intangible assets should usually be excluded because this kind of asset is usually the one for which the discrepancy between book and market value may be highest. However, given the transactional net margin method will be tested at the level of the less complex party to the transaction, it is expected that there will be limited intangibles involved and that valuation of intangibles should not be a big issue in practice.

*How should assets be valued?*

169. Business commentators who responded to the questionnaire on profit methods consider that while the market value of assets should ideally be used in the determination of the net profit to assets indicator, this is not feasible in practice. As a consequence business commentators recommend that for practical reasons, the TP Guidelines should accept (but not necessarily impose) that the analysis use book value of assets. For business commentators, the key issue in a market value approach is that while it may be possible to value the taxpayer’s tangible and intangible assets at market value, although very time-consuming and costly, it would be practically impossible to determine the market value of the operating assets held by the third party comparable companies. As a result, the benefits associated with valuing the taxpayer’s assets on a market value basis would appear limited as this would affect the comparability standard with regard to the independent companies. Business commentators therefore consider that imposing a market value approach would make the analysis either impractical or too uncertain or burdensome both for taxpayers and tax administrations. They recognise however that a book value approach also has limitations, in particular when there are significant differences between book and market value.

170. The Working Party discussed these comments and noted that using book value would possibly distort the result between those enterprises that have depreciated their assets and those that have more recent assets with on-going depreciation. Given that availability and reliability of comparable data is one of the criteria that should influence the choice of the transfer pricing method and of the most reliable financial indicator, the Working Party considers that in those cases where market value cannot practically be determined in a reasonably reliable manner for both the taxpayer and the comparables, and where book value is susceptible of producing distorted outcomes because of significant differences from market value, another financial indicator should be selected (for instance the net profit weighted against an appropriate base other than assets), or another transfer pricing method used that provides a more reliable answer.

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22. Return on capital employed (ROCE) is generally computed on an asset base that excludes cash and non-operating investments. Similar comments as the ones on return on assets (ROA) apply to ROCE.

**D - Other possible net profit margin indicators**

171. The TP Guidelines only refer to the “net profit margin relative to an appropriate base (*e.g.* costs, sales, assets)”. Some other types of financial indicators were however mentioned by business commentators in their responses to the questionnaire on profit methods.

172. It was suggested that depending on the industry, it may be useful to look at other denominators where independent data may exist, such as: square metres 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 other possible 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 enough comparable information to support the application of the method (see paragraph 125 above).

## 7. APPLICATION OF A TRANSACTIONAL PROFIT SPLIT METHOD: DETERMINING THE COMBINED PROFIT TO BE SPLIT

Note: The comments in this note 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 reliable method to be used.

### Introduction

173. As noted at paragraph 3.5 of the TP Guidelines, “the profit split method first identifies the profit to be split for the associated enterprises from the controlled transactions in which the associated enterprises are engaged. [...] The combined profit may be the total profit from the transactions or a residual profit intended to represent the profit that cannot readily be assigned to one of the parties, such as the profit arising from high-value, sometimes unique, intangibles.”

174. The TP Guidelines do not provide much guidance as to how to determine the combined profit. This note discusses two main types of issues in this respect: issues in relation to accounting standards (Section A) and issues in relation to the selection of net, operating or gross profits as the basis for a transactional profit split (Section B).

175. It should be noted that under the transactional profit split method, the same principles should be applied to split losses as to split profits. References to “combined profits to be split” should therefore be taken as applying equally to combined losses in appropriate circumstances. Note that in order to be arm’s length, a loss split should be in line with an arm’s length allocation of risks between the parties (see in particular paragraph 1.27 of the TP Guidelines).

### A - Accounting standards

176. There is wide recognition, among countries and business commentators who responded to the questionnaire on profit methods, of the significance of the issues posed by the lack of harmonised accounting standards when determining the combined profit to be split in a transactional profit split method. In order to determine the combined profit, the accounts of the parties need to be put on a common basis as to accounting practice and currency, and then combined. Several commentators note that the determination of the combined profit is one of the most important and difficult issues when applying a profit split method.

177. It is also fair to recognise that similar issues surrounding the definition of the appropriate measure of profits may arise in the application of a cost plus, resale minus or transactional net margin method. One example is the effect of different asset-depreciation rules in the application of a cost plus or cost-based TNMM.

178. The Working Party considers that the OECD should not be prescriptive as to the choice of the accounting standards or currency rate to be used in the determination of the combined profits. Rather, a flexible approach should be favoured, that will take account of the facts and circumstances of each case. Because the choice of accounting standards can have significant effects on the determination of the profits

to be split, the choice should be made in advance of applying the method, should be documented, and should be applied consistently over the lifetime of the arrangement.

179. As noted above, the transactional profit split method identifies the profit to be split for the associated enterprises *from the controlled transactions* [emphasis added] in which the associated enterprises are engaged. Accordingly, the combined profit to be split should only be that arising from the controlled transaction(s) under review. In determining that profit, it is essential to first identify the relevant transactions to be covered by the profit split. It is also essential to identify the level of aggregation, see paragraph 1.42-1.44 of the TP Guidelines.

180. Where a taxpayer has controlled transactions with more than one associated enterprise, it is also necessary to identify the parties in relation to those dealings and the profits to be split among them.

181. Financial accounting will generally be the starting point for determining the profit to be split in the absence of harmonized tax accounting standards. In this respect, the ongoing convergence between IAS/IFRS and US GAAP standards is expected to simplify the tasks of tax authorities and taxpayers in the future.

182. The use of 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. Experience shows however that the use of multiple allocation keys to arrive at the expenses and/or income attributed to the product-line or division may lessen the reliability of the data for these purposes. Care should be exercised in evaluating whether this cost accounting data is sufficiently reliable to be of use in the application of the arm's length principle. See also Section B of the Issues note "Access to the information needed to apply or review the application of a transactional profit method".

183. Once the combined profit is determined using a common set of accounting rules such as financial or cost accounting, and the arm's length allocation of that combined profit among the parties is determined, a variety of mechanisms can be implemented to achieve the arm's length profit split. For instance, a joint venture or partnership agreement is sometimes set up among the parties in order for them to share the combined profit from the controlled transaction. In other cases, the transfer price for the controlled transaction (*e.g.* a licence to use intangibles) is set according to a formula that seeks to achieve the arm's length profit split between the parties (*e.g.* between the licensor and the licensee). These mechanisms and the transactions that go with them are subject to domestic tax rules in order to determine the taxable profits in each jurisdiction. In other words, the transactional profit split only determines which profits (or losses) should be attributed to the parties to a controlled transaction. It does not deal with the issue of how these profits (or losses), once attributed, are taxable (or deductible) since this is a matter to be determined by domestic law.

## **B - The use of operating or gross profits in the transactional profit split method**

184. This Section discusses different possible measures of profits arising from controlled transactions when applying a transactional profit split method (see paragraphs 179 above in relation to the transactional focus of this method),

**B.1 Different measures of profits**

185. As noted at paragraph 3.17 of the TP Guidelines, generally, the combined profit to be split is the operating profit.<sup>23</sup> 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).

186. In some circumstances, revenue splits have been observed, whereby the parties share only the revenues and no costs. One example is found in the consultancy business where a team of consultants from several entities located in different jurisdictions is formed to serve a client on a single project and agrees to share the fees amongst them.

187. Depending on the facts and circumstances of the case, the combined profits to be split can also be determined at an intermediary level below gross profits but above operating profits. For example, if the thrust of the method is to use operating profits, specific items may need to be excluded from the calculation because they do not relate to the transaction under review (such as certain corporate overheads in some circumstances).

188. This can be illustrated as follows. Assume A and B are two related companies 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 reliable method to be used is a residual profit split method, that the manufacturing activities of A and B are benchmarkable transactions that should be allocated an initial return of 10% of the Cost of Goods Sold<sup>24</sup> 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

23. While paragraph 3.17 of the TP Guidelines was drafted in the context of a contribution analysis, it applies in fact to the splitting of the combined profit to be split, whether determined under a contribution or under a residual analysis (see paragraph 1 above for a definition of the combined profit to be split).

24. See Issues note “Transactional profit split method: reliability of a residual analysis and a contribution analysis”, Section A for a discussion of benchmarkable functions, assets and risks and of the initial return allocated under a residual analysis.

**Step one: determining the initial return for the benchmarkable manufacturing transactions (Cost of Goods Sold + 10% in this example)**

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

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

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

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

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

Total profits allocated to A : 6 (initial return) + 26.57 (residual) = **32.57**  
 Total profits allocated to B : 17 (initial return) + 35.43 (residual) = **52.43**  
**Total = 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 profit to be split):*

	A	B	Combined A+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

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

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

Total profits allocated to A : 6 (initial return) + 30.43 (residual) - 3 (overhead expenses) = **33.43**  
 Total profits allocated to B : 17 (initial return) + 40.57 (residual) - 6 (overhead expenses) = **51.57**  
**Total = 85**

189. As shown in the above example, excluding some specific items from the determination of the combined profit 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.

190. 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 reliable 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.

191. This can be illustrated as follows. Assume the facts are the same as in the example at paragraph 188 above and assume the overhead expenses are not excluded from the determination of the residual profit to be split.

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

Same as at paragraph 188.

**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 188, case a)

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

	A	B	Combined A+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

Combined Operating Profit before intangible asset expenditure: 155

Profit already allocated (initial returns for manufacturing transactions): 23

Residual profit before intangible asset expenditure to be split in proportion of A's and B's intangible asset expenditure: 132

Residual profit allocated to A :  $132 * 30/70 = 56.57$

Residual profit allocated to B :  $132 * 40/70 = 75.43$

Total profits allocated to A : 6 (initial return) + 56.57 (residual) - 30 (intangible asset expenditure) = 32.57

Total profits allocated to B : 17 (initial return) + 75.43 (residual) - 40 (intangible asset expenditure) = 52.43

**Total = 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.

192. 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 188 above).

193. Where the combined profit to be split is determined as the gross profit or as a profit measure that is above operating profits, each party then subtracts its own expenses that are below the level of the combined profit. One implication is that it is possible in such cases that one party makes operating profits while the other makes operating losses after the application of the profit split.

## **B.2 Factors that may affect the choice among various measures of profits**

194. The choice of what measure of profits to use should depend on the facts and circumstances of the case, in particular on the comparability (including functional) analysis of the controlled transactions under review.

195. For example, in some cases corporate overheads might be left for the account of the parties, *i.e.* the combined profits might be calculated before deduction of these costs. On the other hand, in such a case, any related party expense that may be included below the line (*e.g.* management fees or fees for other services) would deserve careful consideration in order to ensure that it is at arm's length and does not distort the application of the method.

196. It is essential to make a sufficiently reliable determination in advance of the implementation of the method of which party is responsible for what costs and risks as well as for what revenue items, and to ensure that such allocation is consistent with the arm's length principle.

197. Given the significant effects the choice of a measure of profits can have on the outcome of the application of the method, the choice should be made in advance of applying the method (at least in cases where the profit split method is used by the taxpayer to set the remuneration of controlled transactions<sup>25</sup>), should be documented, and should be applied consistently over the lifetime of the arrangement.

198. The choice of the profit measure may also be affected by the extent to which the taxpayer is able to analyse its financial results. Gross profit splits may pose consistency issues due to the differences that may exist in different accounting rules for the allocation of certain expenses between cost of sales, selling and distribution expenses and operating expenses.

199. Operating profits are generally defined in a more consistent manner, but they require an allocation of operating expenses to be made to the controlled transactions under review. Where a transactional profit split is applied at the level of operating profits, operating expenses that can be identified with a particular transaction should be allocated to it. Where operating expenses might justifiably relate to more than one transaction, a credible allocation key that is appropriate to the circumstances of the case (*e.g.* third party turnover, time) would be required. It is important to ensure that the allocation key does not distort the segmented results for the purposes of the arm's length analysis.

200. In appropriate circumstances, the choice between operating or gross profits may also be affected by the availability of comparable external data to support the profit split.

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25. In cases where the profit split is used as an *ex post facto* sanity check, prior documentation might not be available.

### **B.3**      *Gross profits*

201.      The TP Guidelines at paragraph 3.17 give one example of the use of a gross profit split in the case of an MNE that engages in highly integrated worldwide trading operations, involving various types of property. In addition several business commentators consider that a split of gross profits may be more reliable in the case of global trading operations and in certain other contexts.

**Countries have contrasting experiences with the use of gross profit splits in global trading operations and countries have expressed scepticism in this respect. Comments from the business community are invited on whether the example at paragraph 3.17 of the TP Guidelines is still regarded as a valid one.**

### **B.4**      *Operating profits*

202.      Operating profits generally refer to operating profits before exceptional items, interest and tax. In effect income taxes are generally not taken into account in the determination of the combined profits to be split as they are generally not relevant to the determination of transfer prices. Outside the financial industry, non-trading interest income and expenses and non-trading foreign exchange gains and losses are also generally to be excluded. However, there are also very exceptional cases where interest and / or taxes should be taken into account at arm's length in the determination of the profit to be split.

203.      Exceptional and extraordinary items of a non-recurring nature are also generally excluded although there may be particular cases where it would be appropriate to include them, *e.g.* where they are related to the controlled transaction under review (for instance, exceptional depreciation of a capital asset that is a value driver of the transaction under review) and where independent parties at arm's length would have agreed to share them. Even where exceptional and extraordinary items are excluded from the determination of the combined profits to be split, it may be useful to review them because they can provide useful information, for instance on the risks borne by the taxpayer.

204.      Issues around the determination of operating profits in a profit split, such as issues in relation to depreciation and amortisation, are similar to those encountered when determining the net profit margin in the context of a TNMM. See Issues note "Application of TNMM: selection and determination of the net profit margin indicator".

## 8. TRANSACTIONAL PROFIT SPLIT METHOD: RELIABILITY OF A RESIDUAL ANALYSIS AND A CONTRIBUTION ANALYSIS

Note: The comments in this note 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 reliable method to be used.

205. The TP Guidelines note at paragraph 3.15 that “[t]here are a number of approaches for estimating the division of profits, based on either projected or actual profits, as may be appropriate, that independent enterprises would have expected, two of which are discussed in the following paragraphs. These approaches -- contribution analysis and residual analysis -- are not necessarily exhaustive or mutually exclusive.” Paragraph 3.23 further notes that “[t]his Report does not seek to provide an exhaustive catalogue of ways in which the 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 operating at arm’s length.”

206. This note discusses the cases where a residual analysis can be more reliable than a contribution analysis and the cases where a contribution analysis can be more reliable than a residual analysis.

207. There is consensus among countries and among the business commentators who responded to the questionnaire on profit methods that there appears to be no reason to set a hard and fast hierarchy for the profit split methods and that the choice between a contribution analysis, a residual analysis or any other possible approach should be made in the light of the particular facts and circumstances of each case. The use of either approach may present risks and difficulties and the choice should always come down to which is the most appropriate in each case. For either approach, full information relating to the comparability including functional analysis of the controlled transaction under review is essential, in particular information about the functions, assets and risks of all the enterprises involved in the transaction.

208. In fact, as noted at paragraph 3.15 of the TP Guidelines, the contribution analysis and residual analysis are not necessarily mutually exclusive. The allocation of a residual profit may be seen as a contribution analysis relating to the residual profit, even where the entirety of the residual profit is allocated to one party.

### **A - When a residual analysis can be more reliable than a contribution analysis**

209. When applying a transactional profit split, in general, a residual analysis is likely to be more reliable than a contribution analysis where one or more party(ies) to the transaction perform(s) functions, use(s) assets or assume(s) risks (hereafter the “benchmarkable functions, assets and risks”) for which an arm’s length remuneration can be determined using either a traditional transaction method or a transactional net margin method, on the basis of comparisons with comparable uncontrolled transactions (whether internal or external comparables). In such cases, a residual analysis that first attributes an arm’s length remuneration to said benchmarkable functions, assets and risks before determining the residual profit to be split can be more reliable than a contribution analysis alone. Typically, a residual analysis

would be used where the parties perform differing benchmarkable functions but all use valuable non-benchmarkable intangible assets and / or bear significant non-benchmarkable risks.

210. It is accordingly suggested to amend paragraphs 3.19 to 3.21 of the TP Guidelines in order to provide a clearer definition of the residual approach and to replace in these paragraphs the words “basic return” in order to reflect the fact that the key point is not whether the return is “basic”, “low” or “high”, but rather whether there are uncontrolled transactions comparable to segments of the controlled transaction under review, for which an arm’s length remuneration can be determined using a traditional transaction method or a transactional net margin method. The suggested redraft of these paragraphs is as follows (note that further consistency changes might be required in other parts of the TP Guidelines):

3.18a As noted at paragraphs 3.15 and 3.23, there are a number of approaches to profit splits, so that the approaches to residual analyses that are described below are not intended to rule out other possible approaches that may be found more reliable in relevant circumstances.

3.19 A residual analysis divides the combined profit from the controlled transactions under examination in two stages. In the first stage, each participant is allocated sufficient profit to provide it with a basic return appropriate for the type of transactions in which it is engaged. Ordinarily this basic return would be determined by reference to the market returns achieved for similar types of transactions by independent enterprises. Thus, the basic return would generally not account for the return that would be generated by any unique and valuable assets possessed 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 that might indicate how this residual would have been divided between independent enterprises. Indicators of the parties' contributions of intangible property and relative bargaining positions could be particularly useful in this context. Ordinarily, in the first stage, each participant is allocated an arm’s length remuneration for its benchmarkable functions performed, assets used and risks assumed in 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, the initial remuneration would not account for the return that would be generated by any non-benchmarkable functions performed, assets used and risks assumed 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 same guidance as described at paragraphs 3.16 to 3.18 for splitting the combined profit under a contribution analysis. Indicators of the parties' contributions of intangible property, of the risks they assume and of the functions they perform could be particularly useful in this context.

Note: Definition to be added to the Glossary: “Benchmarkable functions, assets and risks are functions, assets and risks for which reasonably reliable comparables exist.”

~~3.20 The residual could derive from the application of other methods. For example, market data from traditional transaction methods could assist in the preliminary ascertainment of normal profits attributable to associated enterprises where one enterprise manufactures a unique product using proprietary processes and then transfers the product to another associated enterprise for further processing using other proprietary processes and for distribution~~

~~3.21 One~~ An alternative approach to a residual analysis would could seek to replicate the outcome of bargaining between independent enterprises in the free market. In this context, in the first stage, the basic return 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.

211. As noted by one business commentator, a residual profit split analysis can lead to attributing a preferential claim to profits to one set of activities (the benchmarkable functions), while the remaining activities share the profits or losses that exist after making such preferential payments. This illustrates the fact that whatever approach is taken, it should achieve a sharing among the parties of the profits or losses that is consistent with the comparability analysis and in particular with the functional analysis (*i.e.* the review of the functions performed taking account of the assets used and risks assumed) and with the contractual relationship of the parties to the extent it is at arm's length (see in particular paragraphs 1.27 to 1.29 of the TP Guidelines).

#### **B - When a contribution analysis can be more reliable than a residual analysis**

212. Where it is not possible to apply a traditional transaction method or a transactional net margin method to allocate an arm's length initial remuneration for benchmarkable functions performed, assets used and risks assumed in the controlled transaction under review, for instance due to the lack of sufficiently reliable comparable data, a contribution analysis can be more reliable than a residual analysis.

213. A contribution analysis can also be more reliable than a residual analysis in the case where there are direct third party data that can be used to determine the profit split.

214. At least one country reports having successfully applied a contribution analysis approach to calculate the appropriate profit split for associated enterprises engaged in trade facilitation.

215. It is the experience of several OECD countries that, where an MNE group performs highly integrated business and the profit is derived from overall functions / activities, a contribution analysis can be useful. A typical example is global trading, in which human functions related to the transaction contribute largely to the making of profits, and the compensation of the people involved in the transaction is generally related to the profits derived. In such cases, a contribution analysis can be useful, based on people-related factors such as compensation which expressly reflects the performance of the people engaged in the transaction.

## 9. APPLICATION OF A TRANSACTIONAL PROFIT SPLIT METHOD: HOW TO SPLIT THE COMBINED PROFIT

Note: The comments in this note 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 controlled transaction and the nature and extent of information that is available on possible comparables, a transactional profit split method is considered the most reliable method to be used.

### A - General principle. What is an arm's length division of profits under a profit split method

216. Existing guidance on how to achieve an arm's length division of profits in a profit split method is found at paragraphs 3.5 to 3.25 of the TP Guidelines.

217. In particular, paragraph 3.5 indicates that "the profit split method seeks to [determine] the division of profits that *independent enterprises would have expected to realise from engaging in the transaction or transactions* [emphasis added]" and that "profits between the associated enterprises [are to be split] 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* [emphasis added]." In the same vein, paragraph 3.13 notes that "In using the 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 realised." These paragraphs establish a clear benchmark against what independent parties in comparable conditions would have done.

218. In order to clarify the role of external data in applying a transactional profit split method, it is suggested to amend paragraphs 3.6, 3.11 and 3.16 of the TP Guidelines as follows (proposed additions in underlined font, proposed deletions in strikethrough font):

3.6 ~~One strength of the~~ The profit split method is that it generally does not rely directly on closely comparable transactions, and it can therefore be used in cases when no such transactions between independent enterprises can be identified. Where available and reasonably reliable, external data from independent enterprises can be relevant in the profit split analysis to support the division of profits that would have been achieved between independent parties at arm's length. In the absence of more direct evidence of how independent parties at arm's length would have split the profit in comparable transactions, however, ~~The allocation of profits is based on the division of functions (taking account of the division of the assets and risks) between the associated enterprises themselves. External data from independent enterprises is~~ can also be relevant in the profit split analysis primarily ~~to assess the value of the contributions that each associated enterprise makes to the transactions, and not to determine directly the division of profit. In effect, the fundamental assumption in Chapter III of the TP Guidelines is that independents would have split the combined profit in proportion to the value of their respective contributions to the generation of profit in the transaction.~~ As a consequence, the profit split method 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.

[...]

3.11 If the profit split method were to be used by associated enterprises to establish transfer pricing in controlled transactions, 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. One example is the case where independent enterprises would have established in a joint venture relationship. Generally, conditions established in this manner would have to be based upon projected profits rather than actual profits, because it is not possible for the taxpayers to know what the profits of the business activity would be at the time the conditions are established.

[...]

3.16 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 what independent enterprises would have expected to realize from engaging in comparable transactions. This division can be supported by external data from independent enterprises where such data are available and reasonably reliable. In the absence of such reliable data, 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 ~~supplemented as much as possible by external market data that indicate how independent enterprises would have divided profits in similar circumstances~~. 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.

219. A transactional profit split method can be used either to ~~establish~~ set transfer pricing in a controlled transaction (*ex ante* approach) or to test whether the outcome of a controlled transaction is arm's length ~~for instance as a sanity check~~ (*ex post* approach). In an *ex ante* approach, the parties would be expected to agree in advance on the allocation keys or criteria that will be used to support the division of profits.

## **B - Criteria or allocation keys used to split the combined profit<sup>26</sup>**

### ***B.1 General requirements***

220. As noted at paragraph 3.5 of the TP Guidelines, under the 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. Business commentators who responded to the questionnaire on profit methods and countries all agree that the relevance of external or internal data and the criteria used to achieve an arm's length division of the profits depends on the facts and circumstances of the case.

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26. As noted at paragraph 3.5 of the TP Guidelines, the combined profit may be the total profit from the transactions or a residual profit intended to represent the profit that cannot readily be assigned to one of the parties, such as the profit arising from high-value, sometimes unique, intangibles. In addition, as noted in the note on "Determining the combined profit to be split", references to "combined profits" should be taken as applying equally to combined losses in appropriate circumstances.

221. It is therefore not desirable to establish a prescriptive list of criteria or allocation keys. It is however possible to identify a number of general requirements that should be satisfied by the criteria or allocation keys used, *i.e.* they should:

- Be consistent with the comparability (including functional) analysis of the controlled transaction under review, and in particular reflect the allocation of risks among those parties (subject to the risks being real and the allocation of risks being arm's length, see paragraph 1.27 of the TP Guidelines),
- Be consistent with those which would have been agreed between independents in comparable circumstances, given the profit split method seeks to determine the division of profits that independent enterprises would have expected to realise from engaging in the transaction (see paragraph 3.5 of the TP Guidelines)
- Be independent of transfer pricing policy formulation, *i.e.* they should be based on objective data (*e.g.* sales to unrelated parties), not on data relating to the remuneration of controlled transactions (*e.g.* sales to related parties),
- Be consistent with the type of profit split approach (*e.g.* contribution analysis, residual analysis, or other; *ex ante* or *ex post* approach),
- Be capable of being measured in a reasonably reliable manner.

222. In addition:

- If a transactional profit split method is used to establish transfer pricing in controlled transactions (*ex ante* approach), the criteria or allocation keys should be agreed in advance of the transaction and documented,
- The person using a transactional profit split method (taxpayer or tax administration) should be prepared to explain the choice of the method as well as the way it is implemented, and in particular the criteria or allocation keys used to split the combined profit, and
- The criteria or allocation keys should be used consistently over the life-time of the arrangement, including during loss years, unless specific circumstances justify a re-negotiation between the parties.

223. Finally, the criteria should be supported by external data, internal data, or both, as discussed in Sections C and D below.

## **B.2 Allocation keys**

224. In practice, the division of the combined profits under a profit split method is generally achieved using one or more allocation key(s). 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).

225. Considerable caution and judgment must be exercised in the use of allocation keys to ensure they remain appropriate to the particular circumstances of the case, provide a reasonably reliable approximation of the division of profits that would have been agreed between independent parties at arm's length, and do not become formulaic.

*Different allocation keys selected on a case-by-case basis*

226. It is not desirable to establish a prescriptive list of allocation keys to be used in profit splits, and the relevance and acceptability of any allocation key or combination thereof should be evaluated based on the facts and circumstances of the case. See paragraphs 220 to 223 above for a discussion of general conditions.

227. Where allocation key(s) are used to split the combined profits in proportion to the relative contributions of the parties, they should appropriately reflect the main value driver(s) of the transaction, *i.e.* there should be a strong correlation between their base and the creation of the combined profit in the context of the controlled transaction. 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 the most common. 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, square footage of retail points, etc. are also sometimes encountered.

*Asset-based allocation keys*

228. Asset-based or capital-based allocation keys can be used where there is a strong correlation between tangible or intangible assets / capital employed and creation of value in the context of the controlled transaction. See paragraph 3.24 of the TP Guidelines for a brief discussion of also of splitting the combined profit by reference to capital employed.

229. In order for an allocation key to be meaningful, it should be applied consistently to all the parties to the transaction. Book value of tangible or intangible assets may present significant discrepancies among the parties, for instance where one party has acquired and capitalised assets while the other has developed them internally and expensed them. It can be the case that the parties to the transaction follow different depreciation rules. It can also be the case that both parties employ assets of comparable market value, but which have been acquired in different time periods and therefore have materially different book values. While ideally the market value of assets employed (whether owned or rented) in the transactions should be used, such valuation might be extremely time-consuming and costly in practice, especially in relation to intangible assets.

230. One particular circumstance where the profit split method is used is the case where both parties to the transaction use significant unique intangibles. Intangible assets pose difficult issues in relation both to their identification and to their valuation.

231. 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. Relevant intangible assets might potentially include rights to use industrial assets such as patents, trademarks, trade names, designs or models, as well as copyrights of literary, artistic or scientific work (including software) and intellectual property such as know-how and trade secrets. They may also include customer lists, distribution channels, unique names, symbols or pictures. Depending on the nature of the intangible assets, on whether they were developed or acquired, and on the applicable accounting standards, intangibles might be recorded in the balance sheet or not. An essential part of a profit split analysis is to identify what intangible assets are owned by each party to the transaction and what their relative value is.

232. Existing guidance on valuation of intangible property is found at Chapter VI of the TP Guidelines. Intangible valuation should take account of both the perspective of the transferor and of the transferee (see paragraph 6.14 of the TP Guidelines). It is affected by a number of factors among which are

the expected benefits from the intangible property, the nature of the property right and the restrictions that may be attached to it (restrictions in the way it can be used or exploited, geographical restrictions, time limitations), the extent and remaining duration of its legal protection (if any), and any exclusivity clause that might be attached to the right. See also examples at AN-15 of the TP Guidelines on intangible property and uncertain valuation.

#### *Cost-based allocation keys*

233. An allocation key based on expenses may be appropriate where it is possible to identify a strong correlation between expenses incurred and value added. For example, marketing expenses may be an appropriate key for a distributor-marketer if advertisement generates material marketing intangibles, *e.g.* in consumer goods which are affected by advertisement. Research and development expenses may be suitable for a manufacturer if they relate to the development of significant trade intangibles such as patents. Compensation is frequently used in situations where people functions are the primary factor in generating the combined profit.

234. Cost-based allocation keys have the advantage of simplicity. It is however not always the case that a strong correlation exists between expenses and value.

235. 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. Cost-based allocation keys can also pose consistency problems where they are applied to parties situated in countries with significantly different level of costs (*e.g.* a high labour-cost country and a low labour-cost country).

#### *Timing Issues*

236. 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 appropriate for some cases, while in some other cases it may be more appropriate to use accumulated expenditure 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 paragraph 225 above, considerable caution and judgment must be exercised to ensure that the allocation key is appropriate to the particular circumstances of the case and provides a reasonably reliable approximation of the division of profits that would have been agreed between independent parties at arm's length.

#### **C - Reliance on external data**

237. As noted at paragraph 3.5 of the TP Guidelines, in a transactional profit split method, the profits are to be split 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. External data where available can provide valuable information to support the division of profits. However, this is subject to the data being both relevant and reasonably reliable, as external data as well as internal ones should satisfy the general conditions outlined at paragraphs 220 to 223 above.

238. Such external data are not abundant in practice. Business commentators who responded to the questionnaire on profit methods suggested some examples of possible sources of external data that might usefully assist the determination of criteria to split the profits, depending on the facts and circumstances of the case and of their satisfying the general conditions outlined at paragraphs 220 to 223 above:

- Joint-venture arrangements between unrelated 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.
- Franchise agreements showing how a franchisor and franchisee may expect to share the profit of the franchise.
- Uncontrolled license or other agreements that have pricing between the parties that is dependent upon profits, such as license agreements that call for an explicit sharing of profits, license agreements that have royalty rates that vary depending upon profits, or third party transactions with contingent payment terms generally.

#### **D - Reliance on internal data**

239. As noted at paragraph 3.6 of the TP Guidelines, “[o]ne strength of the profit split method is that it generally does not rely directly on closely comparable transactions, and it can therefore be used in cases when no such transactions between independent enterprises can be identified.” The fact that, in some cases, external data can be used to support the division of the combined profits under a profit split method does not invalidate the reliability of a profit split analysis that is not based on external data. In fact, several business commentators and countries indicate that they have no or very limited experience of using external data to support the division of the combined profits<sup>27</sup> in a profit split method. One obvious reason for this is that the profit split method is especially selected in those cases where there are no or insufficient reliable external data available.

240. Where relevant external data of sufficient reliability are lacking to support the division of the combined profit, consideration should be given to internal data, which are more available and may successfully be used as a means of establishing or testing the arm’s length nature of the division of profits. The types of such internal data will depend on the facts and circumstances of the case and should satisfy the conditions outlined at paragraphs 220 to 223 above. They will frequently be extracted from the taxpayers’ cost accounting or financial accounting.

241. 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 also 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.

242. Cost-based allocation keys (*e.g.* marketing expenses; research and development expenses; compensation; etc.) are generally based on data extracted from the taxpayers’ profit and loss accounts. It may also 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. For instance, if it is found that in a particular case the combined profits could reasonably be split at

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27. See footnote 1. In a residual approach, external data are generally available to support the allocation of routine profit to routine functions, assets and risks.

arm's length based on the respective marketing efforts of each of the parties to the transaction, then the marketing expenditures related to the controlled transaction at hand could be extracted from the accounting systems of each of the participants to the transaction in order to determine 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.

243. Internal data may also be helpful where the allocation key is not a statutory accounting one but one that is found in the 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, square footage of retail points, etc. See comment on the use of multiple allocation keys at paragraph 182 of the Issues note "Determining the combined profit to be split".

244. 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 an appropriate functional analysis which takes into account all the economically significant functions, assets and risks contributed by the parties to the controlled transaction, including an evaluation of the relative importance of those functions, assets and risks to the value added to the controlled transaction. In practice, the most difficult part is to identify the relevant contributions of the significant intangibles and significant risks and the importance, relevance and measurement of the factors which gave rise to these significant intangibles and risks. A discussion of how to split the combined profit in cases involving intangibles is found in a separate note "Application of transactional profit methods and unique contributions", Section B.2.

245. Internal data can be particularly difficult for tax administrations to verify in the context of audits, and taxpayers using internal data to support the division of profits under a profit split method should be prepared to provide tax administrations with all the information that might be needed to assess the reliability of such data, including, where appropriate, information from the other jurisdiction(s). This concern is generally alleviated when a profit split is used in the context of MAP cases or MAP APAs.

## 10. OTHER METHODS

246. Paragraph 1.68 of the TP Guidelines indicates that multinational enterprises "retain the freedom to apply methods not described in this Report to establish prices provided those prices satisfy the arm's length principle in accordance with these Guidelines". Comments were invited from the public on what type of other methods not described in the TP Guidelines (hereafter "other methods") might be used in practice and for what reasons.

247. Examples of such "other methods" include the use of internal pricing models that might be used by the same taxpayer in comparable uncontrolled transactions (internal comparables); pricing models such as option pricing formula (as discussed in the study that was released in September 2004 "Employee stock option plans: impact on transfer pricing", available on the OECD Internet site at <http://www.oecd.org/dataoecd/35/37/33700408.pdf>); and the use of a discounted cash flow analysis in evaluating the income attributable to intangible property as a means of evaluating alternatives to the transaction entered into by the associated enterprises, or for other purposes (as discussed at paragraph 3.22 of the TP Guidelines). There are also examples of fair market valuation approaches used in non-tax contexts that may be useful under the appropriate facts and circumstances.

248. Several comments were received from the public in relation to the possible use of "other methods" in the financial industry and in particular for global trading of financial instruments. The OECD's view of how to apply the arm's length principle to global trading of financial instruments is found in Part III of the Report on the Attribution of Profits to Permanent Establishments that was released on the OECD Internet site in December 2006, see [http://www.oecd.org/document/36/0,2340,en\\_2649\\_37989746\\_37861284\\_1\\_1\\_1\\_1,00.html](http://www.oecd.org/document/36/0,2340,en_2649_37989746_37861284_1_1_1_1,00.html).

249. The Working Party considers that in view of the objective which is to find a reasonable solution to all transfer pricing cases, the consideration of "other methods" should not be ruled out, but that such "other methods" should not be used in substitution for OECD approved methods where the latter are appropriate to the facts and circumstances of the case and capable of providing a workable solution. In addition, in order for any such "other method" to be acceptable, a basic requirement is that it should satisfy the arm's length principle *i.e.* be comparable with what independent parties at arm's length would have agreed to in comparable circumstances, in view of the comparability (including functional) analysis of the controlled transaction. As noted at paragraph 1.68 of the TP Guidelines, taxpayers should maintain and be prepared to provide documentation regarding how their transfer prices were established. Where the transfer pricing method is not one of the OECD recognised methods, the taxpayer's documentation should include an explanation of why OECD recognised methods were regarded as non-appropriate or non-workable in the circumstances of the case and of the reasons why the selected "other method" was regarded as providing a better solution.

### *Global Formulary apportionment*

250. The Working Party re-discussed global formulary apportionment in the context of its review of Chapter III of the TP Guidelines and agreed that paragraphs 3.58 to 3.74 of the TP Guidelines still adequately reflect the OECD's consensus on that topic.