Annex I to Chapter II

Sensitivity of Gross and Net Profit Indicators

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

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

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

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

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

The example below is for illustration only. It is not intended to provide any guidance on the selection of the transfer pricing method or of comparables, on the efficiency of distributors or on arm's length rates of return, but only

to illustrate the effects of differences between the extent and complexity of the marketing function of a distributor and of comparables.

	Case 1 **The distributor performs a limited marketing function**	**Case 2** **The distributor performs a more significant marketing function**
Sales of product **(For illustration purposes, assume both sell the same volume of the same product on the same market at the same price)**	1 000	1 000
Purchase price from manufacturer taking account of the significance of the marketing function in accordance to the functional analysis	600	480 (*)
Gross margin	400 (40%)	520 (52%)
Marketing expenses	50	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 extent and complexity of the marketing function performed by the distributor (additional expense of 100 plus remuneration of the function of the distributor)

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

Illustration 2: Effect of a difference in the level of risk assumed by a distributor

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

	Case 1 **The distributor does not assume the risk of obsolescence of products because it benefits from a "buy-back" clause whereby all unsold inventory is purchased back by the manufacturer.**	**Case 2** **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.**
Sales of product **(For illustration purposes, assume both sell the same volume of the same product on the same market at the same price)**	1 000	1 000
Purchase price from manufacturer taking account of the obsolescence risk in accordance with the functional analysis	700	640 (*)
Gross margin	300 (30%)	360 (36%)
Loss on obsolete inventory	0	50
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.

3. Under Illustration 2, if a controlled transaction is performed as in case 1 while the third party "comparables" are operating as in case 2, and assuming that the difference in the level of risks is not identified due to

insufficiently detailed information on the third party “comparables”, then the risk of error when applying a gross margin method could amount to 60 (6% x 1 000) instead of 10 (1% x 1 000) if a net margin method is applied. This illustrates the fact that, depending on the circumstances of the case and in particular of the effect of the differences in the level of risks on the cost structure and on the revenue of the “comparables”, net profit margins can be less sensitive than gross margins to differences in the level of risks (assuming the contractual allocation of risks is arm’s length).

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

Illustration 3: Effect of a difference in manufacturers' capacity utilization

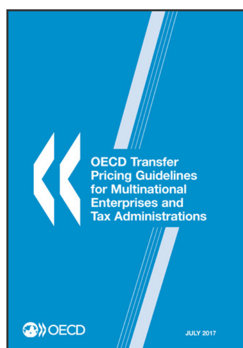
The example below is for illustration only and is not intended to provide any guidance on the selection of the transfer pricing method or of comparables, or on arm's length rates of return, but only to illustrate the effects of differences between the capacity utilisation of a manufacturer and of comparables.

In monetary units (m.u.)	**Case 1** **The manufacturer operates in full capacity: 1 000 units per year**	**Case 2** **The manufacturer operates in excess capacity i.e. only manufactures 80% of what it could manufacture in full capacity: 800 units per year**
Sales of manufactured products (For illustration purposes, assume both manufacturers have the same total capacity, and that they both manufacture and sell the same product on the same market which have the same price of 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.

5. Under Illustration 3, if a controlled transaction is performed as in case 1 while the third party "comparables" are operating as in case 2, and

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



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