

Chapter II

Transfer Pricing Methods

Part I: Selection of the transfer pricing method

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

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

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

2.3 Traditional transaction methods are regarded as the most direct means of establishing whether conditions in the commercial and financial relations between associated enterprises are arm's length. This is because any difference in the price of a controlled transaction from the price in a comparable uncontrolled transaction can normally be traced directly to the commercial and financial relations made or imposed between the enterprises, and the arm's length conditions can be established by directly substituting the price in the comparable uncontrolled transaction for the price of the controlled transaction. As a result, where, taking account of the criteria described at paragraph 2.2, a traditional transaction method and a transactional profit method can be applied in an equally reliable manner, the traditional transaction method is preferable to the transactional profit method. Moreover, where, taking account of the criteria described at paragraph 2.2, the comparable uncontrolled price method (CUP) and another transfer pricing method can be applied in an equally reliable manner, the CUP method is to be preferred. See paragraphs 2.14-2.26 for a discussion of the CUP method.

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

2.5 However, it is not appropriate to apply a transactional profit method merely because data concerning uncontrolled transactions are difficult to obtain or incomplete in one or more respects. The same criteria listed in paragraph 2.2 that were used to reach the initial conclusion that none of the traditional transactional methods could be reliably applied under the circumstances must be considered again in evaluating the reliability of the transactional profit method.

2.6 Methods that are based on profits can be accepted only insofar as they are compatible with Article 9 of the OECD Model Tax Convention, especially with regard to comparability. This is achieved by applying the methods in a manner that approximates arm's length pricing. The application of the arm's length principle is generally based on a comparison of the price, margin or profits from particular controlled transactions with the price, margin or profits from comparable transactions between

independent enterprises. In the case of a transactional profit split method, it is based on an approximation of the division of profits that independent enterprises would have expected to realise from engaging in the transaction(s) (see paragraph 2.114).

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

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

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

2.10 The application of a general rule of thumb does not provide an adequate substitute for a complete functional and comparability analysis conducted under the principles of Chapters I - III. Accordingly, a rule of thumb cannot be used to evidence that a price or an apportionment of income is arm's length.

2.11 It is not possible to provide specific rules that will cover every case. Tax administrators should hesitate from making minor or marginal adjustments. In general, the parties should attempt to reach a reasonable accommodation keeping in mind the imprecision of the various methods and

the preference for higher degrees of comparability and a more direct and closer relationship to the transaction. It should not be the case that useful information, such as might be drawn from uncontrolled transactions that are not identical to the controlled transactions, should be dismissed simply because some rigid standard of comparability is not fully met. Similarly, evidence from enterprises engaged in controlled transactions with associated enterprises may be useful in understanding the transaction under review or as a pointer to further investigation. Further, any method should be permitted where its application is agreeable to the members of the MNE group involved with the transaction or transactions to which the methodology applies and also to the tax administrations in the jurisdictions of all those members.

B. Use of more than one method

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

Part II: Traditional transaction methods

A. Introduction

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

B. Comparable uncontrolled price method

B.1 In general

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

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

2.16 It may be difficult to find a transaction between independent enterprises that is similar enough to a controlled transaction such that no differences have a material effect on price. For example, a minor difference

in the property transferred in the controlled and uncontrolled transactions could materially affect the price even though the nature of the business activities undertaken may be sufficiently similar to generate the same overall profit margin. When this is the case, some adjustments will be appropriate. As discussed below in paragraph 2.17, the extent and reliability of such adjustments will affect the relative reliability of the analysis under the CUP method.

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

2.18 Subject to the guidance in paragraph 2.2 for selecting the most appropriate transfer pricing method in the circumstances of a particular case, the CUP method would generally be an appropriate transfer pricing method for establishing the arm's length price for the transfer of commodities between associated enterprises. The reference to "commodities" shall be understood to encompass physical products for which a quoted price is used as a reference by independent parties in the industry to set prices in uncontrolled transactions. The term "quoted price" refers to the price of the commodity in the relevant period obtained in an international or domestic commodity exchange market. In this context, a quoted price also includes prices obtained from recognised and transparent price reporting or statistical agencies, or from governmental price-setting agencies, where such indexes are used as a reference by unrelated parties to determine prices in transactions between them.

2.19 Under the CUP method, the arm's length price for commodity transactions may be determined by reference to comparable uncontrolled transactions and by reference to comparable uncontrolled arrangements represented by the quoted price. Quoted commodity prices generally reflect the agreement between independent buyers and sellers in the market on the

price for a specific type and amount of commodity, traded under specific conditions at a certain point in time. A relevant factor in determining the appropriateness of using the quoted price for a specific commodity is the extent to which the quoted price is widely and routinely used in the ordinary course of business in the industry to negotiate prices for uncontrolled transactions comparable to the controlled transaction. Accordingly, depending on the facts and circumstances of each case, quoted prices can be considered as a reference for pricing commodity transactions between associated enterprises. Taxpayers and tax administrations should be consistent in their application of the appropriately selected quoted price.

2.20 For the CUP method to be reliably applied to commodity transactions, the economically relevant characteristics of the controlled transaction and the uncontrolled transactions or the uncontrolled arrangements represented by the quoted price need to be comparable. For commodities, the economically relevant characteristics include, among others, the physical features and quality of the commodity; the contractual terms of the controlled transaction, such as volumes traded, period of the arrangements, the timing and terms of delivery, transportation, insurance, and foreign currency terms. For some commodities, certain economically relevant characteristics (e.g. prompt delivery) may lead to a premium or a discount. If the quoted price is used as a reference for determining the arm's length price or price range, the standardised contracts which stipulate specifications on the basis of which commodities are traded on the exchange and which result in a quoted price for the commodity may be relevant. Where there are differences between the conditions of the controlled transaction and the conditions of the uncontrolled transactions or the conditions determining the quoted price for the commodity that materially affect the price of the commodity transactions being examined, reasonably accurate adjustments should be made to ensure that the economically relevant characteristics of the transactions are comparable. Contributions made in the form of functions performed, assets used and risks assumed by other entities in the supply chain should be compensated in accordance with the guidance provided in these Guidelines.

2.21 In order to assist tax administrations in conducting an informed examination of the taxpayer's transfer pricing practices, taxpayers should provide reliable evidence and document, as part of their transfer pricing documentation, the price-setting policy for commodity transactions, the information needed to justify price adjustments based on the comparable uncontrolled transactions or comparable uncontrolled arrangements represented by the quoted price and any other relevant information, such as pricing formulas used, third party end-customer agreements, premia or

discounts applied, pricing date, supply chain information, and information prepared for non-tax purposes.

2.22 A particularly relevant factor for commodity transactions determined by reference to the quoted price is the pricing date, which refers to the specific time, date or time period (e.g. a specified range of dates over which an average price is determined) selected by the parties to determine the price for commodity transactions. Where the taxpayer can provide reliable evidence of the pricing date agreed by the associated enterprises in the controlled commodity transaction at the time the transaction was entered into (e.g. proposals and acceptances, contracts or registered contracts, or other documents setting out the terms of the arrangements may constitute reliable evidence) and this is consistent with the actual conduct of the parties or with other facts of the case, in accordance with the guidance in Section D of Chapter I on accurately delineating the actual transaction, tax administrations should determine the price for the commodity transaction by reference to the pricing date agreed by the associated enterprises. If the pricing date specified in any written agreement between the associated enterprises is inconsistent with the actual conduct of the parties or with other facts of the case, tax administrations may determine a different pricing date consistent with those other facts of the case and what independent enterprises would have agreed in comparable circumstances (taking into considerations industry practices). When the taxpayer does not provide reliable evidence of the pricing date agreed by the associated enterprises in the controlled transaction and the tax administration cannot otherwise determine a different pricing date under the guidance in Section D of Chapter I, tax administrations may deem the pricing date for the commodity transaction on the basis of the evidence available to the tax administration; this may be the date of shipment as evidenced by the bill of lading or equivalent document depending on the means of transport. This would mean that the price for the commodities being transacted would be determined by reference to the average quoted price on the shipment date, subject to any appropriate comparability adjustments based on the information available to the tax administration. It would be important to permit resolution of cases of double taxation arising from application of the deemed pricing date through access to the mutual agreement procedure under the applicable Treaty.

B.2 Examples of the application of the CUP method

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

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

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

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

C. Resale price method

C.1 In general

2.27 The resale price method begins with the price at which a product that has been purchased from an associated enterprise is resold to an independent enterprise. This price (the resale price) is then reduced by an appropriate gross margin on this price (the “resale price margin”)

representing the amount out of which the reseller would seek to cover its selling and other operating expenses and, in the light of the functions performed (taking into account assets used and risks assumed), make an appropriate profit. What is left after subtracting the gross margin can be regarded, after adjustment for other costs associated with the purchase of the product (e.g. customs duties), as an arm's length price for the original transfer of property between the associated enterprises. This method is probably most useful where it is applied to marketing operations.

2.28 The resale price margin of the reseller in the controlled transaction may be determined by reference to the resale price margin that the same reseller earns on items purchased and sold in comparable uncontrolled transactions ("internal comparable"). Also, the resale price margin earned by an independent enterprise in comparable uncontrolled transactions may serve as a guide ("external comparable"). Where the reseller is carrying on a general brokerage business, the resale price margin may be related to a brokerage fee, which is usually calculated as a percentage of the sales price of the product sold. The determination of the resale price margin in such a case should take into account whether the broker is acting as an agent or a principal.

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

2.30 In a market economy, the compensation for performing similar functions would tend to be equalized across different activities. In contrast, prices for different products would tend to equalize only to the extent that those products were substitutes for one another. Because gross profit margins represent gross compensation, after the cost of sales for specific functions performed (taking into account assets used and risks assumed), product differences are less significant. For example, the facts may indicate that a distribution company performs the same functions (taking into account assets used and risks assumed) selling toasters as it would selling blenders, and hence in a market economy there should be a similar level of compensation for the two activities. However, consumers would not

consider toasters and blenders to be particularly close substitutes, and hence there would be no reason to expect their prices to be the same.

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

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

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

2.34 The resale price method also depends on comparability of functions performed (taking into account assets used and risks assumed). It may become less reliable when there are differences between the controlled

and uncontrolled transactions and the parties to the transactions, and those differences have a material effect on the attribute being used to measure arm's length conditions, in this case the resale price margin realised. Where there are material differences that affect the gross margins earned in the controlled and uncontrolled transactions (e.g. in the nature of the functions performed by the parties to the transactions), adjustments should be made to account for such differences. The extent and reliability of those adjustments will affect the relative reliability of the analysis under the resale price method in any particular case.

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

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

2.37 It should be expected that the amount of the resale price margin will be influenced by the level of activities performed by the reseller. This level of activities can range widely from the case where the reseller performs only minimal services as a forwarding agent to the case where the reseller takes on the full risk of ownership together with the full responsibility for and the risks involved in advertising, marketing, distributing and guaranteeing the goods, financing stocks, and other connected services. If the reseller in the controlled transaction does not carry on a substantial commercial activity but only transfers the goods to a third party, the resale price margin could, in light of the functions performed, be a small one. The resale price margin could be higher where it can be demonstrated that the reseller has some special expertise in the marketing of such goods, in effect bears special risks, or contributes substantially to the creation or maintenance of intangible property associated with the product. However, the level of activity performed by the reseller, whether minimal or substantial, would need to be well supported by relevant evidence. This

would include justification for marketing expenditures that might be considered unreasonably high; for example, when part or most of the promotional expenditure was clearly incurred as a service performed in favour of the legal owner of the trademark. In such a case the cost plus method may well supplement the resale price method.

2.38 Where the reseller is clearly carrying on a substantial commercial activity in addition to the resale activity itself, then a reasonably substantial resale price margin might be expected. If the reseller in its activities employs certain assets (e.g. intangibles used by the reseller, such as its marketing organisation), it may be inappropriate to evaluate the arm's length conditions in the controlled transaction using an unadjusted resale price margin derived from uncontrolled transactions in which the uncontrolled reseller does not employ similar assets. If the reseller possesses valuable marketing intangibles, the resale price margin in the uncontrolled transaction may underestimate the profit to which the reseller in the controlled transaction is entitled, unless the comparable uncontrolled transaction involves the same reseller or a reseller with similarly valuable marketing intangibles.

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

2.40 The resale price margin should also be expected to vary according to whether the reseller has the exclusive right to resell the goods. Arrangements of this kind are found in transactions between independent enterprises and may influence the margin. Thus, this type of exclusive right should be taken into account in any comparison. The value to be attributed to such an exclusive right will depend to some extent upon its geographical scope and the existence and relative competitiveness of possible substitute goods. The arrangement may be valuable to both the supplier and the reseller in an arm's length transaction. For instance, it may stimulate the reseller to greater efforts to sell the supplier's particular line of goods. On

the other hand, such an arrangement may provide the reseller with a kind of monopoly with the result that the reseller possibly can realize a substantial turn over without great effort. Accordingly, the effect of this factor upon the appropriate resale price margin must be examined with care in each case. See also paragraphs 6.118 and 6.120.

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

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

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

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

2.44 A company sells a product through independent distributors in five countries in which it has no subsidiaries. The distributors simply market the product and do not perform any additional work. In one country, the company has set up a subsidiary. Because this particular market is of strategic importance, the company requires its subsidiary to sell only its product and to perform technical applications for the customers. Even if all

other facts and circumstances are similar, if the margins are derived from independent enterprises that do not have exclusive sales arrangements or perform technical applications like those undertaken by the subsidiary, it is necessary to consider whether any adjustments must be made to achieve comparability.

D. Cost plus method

D.1 In general

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

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

2.47 Following the principles in Chapter I, an uncontrolled transaction is comparable to a controlled transaction (i.e. it is a comparable uncontrolled transaction) for purposes of the cost plus method if one of two conditions is met: a) none of the differences (if any) between the transactions being compared or between the enterprises undertaking those transactions materially affect the cost plus mark up in the open market; or, b) reasonably accurate adjustments can be made to eliminate the material effects of such differences. In determining whether a transaction is a comparable uncontrolled transaction for the purposes of the cost plus method, the same principles apply as described in paragraphs 2.29-2.34 for the resale price method. Thus, fewer adjustments may be necessary to account for product differences under the cost plus method than the CUP method, and it may be appropriate to give more weight to other factors of comparability described in Chapter I, some of which may have a more significant effect on the cost plus mark-up than they do on price. As under the resale price method (see

paragraph 2.34), where there are differences that materially affect the cost plus mark ups earned in the controlled and uncontrolled transactions (for example in the nature of the functions performed by the parties to the transactions), reasonably accurate adjustments should be made to account for such differences. The extent and reliability of those adjustments will affect the relative reliability of the analysis under the cost plus method in particular cases.

2.48 For example, assume that Company A manufactures and sells toasters to a distributor that is an associated enterprise, that Company B manufactures and sells irons to a distributor that is an independent enterprise, and that the profit margins on the manufacture of basic toasters and irons are generally the same in the small household appliance industry. (The use of the cost plus method here presumes that there are no highly similar independent toaster manufacturers). If the cost plus method were being applied, the mark ups being compared in the controlled and uncontrolled transactions would be the difference between the selling price by the manufacturer to the distributor and the costs of manufacturing the product, divided by the costs of manufacturing the product. However, Company A may be much more efficient in its manufacturing processes than Company B thereby enabling it to have lower costs. As a result, even if Company A were making irons instead of toasters and charging the same price as Company B is charging for irons (i.e. no special condition were to exist), it would be appropriate for Company A's profit level to be higher than that of Company B. Thus, unless it is possible to adjust for the effect of this difference on the profit, the application of the cost plus method would not be wholly reliable in this context.

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

2.50 In addition, when applying the cost plus method one should pay attention to apply a comparable mark up to a comparable cost basis. For instance, if the supplier to which reference is made in applying the cost plus method in carrying out its activities employs leased business assets, the cost basis might not be comparable without adjustment if the supplier in the controlled transaction owns its business assets. The cost plus method relies

upon a comparison of the mark up on costs achieved in a controlled transaction and the mark up on costs achieved in one or more comparable uncontrolled transactions. Therefore, differences between the controlled and uncontrolled transactions that have an effect on the size of the mark up must be analysed to determine what adjustments should be made to the uncontrolled transactions' respective mark up.

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

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

In any of the above circumstances it may be appropriate to supplement the cost plus and resale price methods by considering the results obtained from applying other methods (see paragraph 2.12).

2.52 Another important aspect of comparability is accounting consistency. Where the accounting practices differ in the controlled transaction and the uncontrolled transaction, appropriate adjustments should be made to the data used to ensure that the same type of costs are used in each case to ensure consistency. The gross profit mark ups must be measured consistently between the associated enterprise and the independent enterprise. In addition, there may be differences across enterprises in the treatment of costs that affect gross profit mark ups that would need to be accounted for in order to achieve reliable comparability. In some cases it

may be necessary to take into account certain operating expenses in order to achieve consistency and comparability; in these circumstances the cost plus method starts to approach a net rather than gross profit analysis. To the extent that the analysis takes into account operating expenses, its reliability may be adversely affected for the reasons set forth in paragraphs 2.70 - 2.73. Thus, the safeguards described in paragraphs 2.74 - 2.81 may be relevant in assessing the reliability of such analyses.

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

2.54 The distinction between gross and net profit analyses may be understood in the following terms. In general, the cost plus method will use mark ups computed after direct and indirect costs of production, while a net profit method will use profits computed after operating expenses of the enterprise as well. It must be recognised that because of the variations in practice among countries, it is difficult to draw any precise lines between the three categories described above. Thus, for example, an application of the cost plus method may in a particular case include the consideration of some expenses that might be considered operating expenses, as discussed in paragraph 2.52. Nevertheless, the problems in delineating with mathematical precision the boundaries of the three categories described above do not alter the basic practical distinction between the gross and net profit approaches.

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

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

2.57 In some cases, there may be a basis for using only variable or incremental (e.g. marginal) costs, because the transactions represent a disposal of marginal production. Such a claim could be justified if the goods could not be sold at a higher price in the relevant foreign market (see also the discussion of market penetration in Chapter I). Factors that could be taken into account in evaluating such a claim include information on whether the taxpayer has any other sales of the same or similar products in that particular foreign market, the percentage of the taxpayers' production (in both volume and value terms) that the claimed "marginal production" represents, the term of the arrangement, and details of the marketing analysis that was undertaken by the taxpayer or MNE group which led to the conclusion that the goods could not be sold at a higher price in that foreign market.

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

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

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

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

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

Part III: Transactional profit methods

A. Introduction

2.62 This Part provides a discussion of transactional profit methods that may be used to approximate arm's length conditions where such methods are the most appropriate to the circumstances of the case, see paragraphs 2.1 - 2.12. Transactional profit methods examine the profits that arise from particular transactions among associated enterprises. The only profit methods that satisfy the arm's length principle are those that are consistent with Article 9 of the OECD Model Tax Convention and follow the requirement for a comparability analysis as described in these Guidelines. In particular, so-called "comparable profits methods" or "modified cost plus/resale price methods" are acceptable only to the extent that they are consistent with these Guidelines.

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

B. Transactional net margin method

B.1 In general

2.64 The transactional net margin method examines the net profit relative to an appropriate base (e.g. costs, sales, assets) that a taxpayer realises from a controlled transaction (or transactions that are appropriate to aggregate under the principles of paragraphs 3.9-3.12). Thus, a transactional net margin method operates in a manner similar to the cost plus and resale price methods. This similarity means that in order to be applied reliably, the transactional net margin method must be applied in a manner consistent with the manner in which the resale price or cost plus method is applied. This means in particular that the net profit indicator of the taxpayer from the

controlled transaction (or transactions that are appropriate to aggregate under the principles of paragraphs 3.9-3.12) should ideally be established by reference to the net profit indicator that the same taxpayer earns in comparable uncontrolled transactions, i.e. by reference to “internal comparables” (see paragraphs 3.27-3.28). Where this is not possible, the net margin that would have been earned in comparable transactions by an independent enterprise (“external comparables”) may serve as a guide (see paragraphs 3.29-3.35). A functional analysis of the controlled and uncontrolled transactions is required to determine whether the transactions are comparable and what adjustments may be necessary to obtain reliable results. Further, the other requirements for comparability, and in particular those of paragraphs 2.74-2.81, must be applied.

2.65 A transactional net margin method is unlikely to be reliable if each party to a transaction makes unique and valuable contributions, see paragraph 2.4. In such a case, a transactional profit split method will generally be the most appropriate method, see paragraph 2.115. 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 and valuable contributions involved in the controlled transaction, while the other party does not make any unique and valuable contribution. In such a case, the tested party should be the less complex one. See paragraphs 3.18-3.19 for a discussion of the notion of tested party.

2.66 There are also many cases where a party to a transaction makes contributions that are not unique – e.g. uses non-unique intangibles such as non-unique business processes or non-unique market knowledge. In such cases, it may be possible to meet the comparability requirements to apply a traditional transaction method or a transactional net margin method because the comparables would also be expected to use a comparable mix of non-unique contributions.

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

B.2 Strengths and weaknesses¹

2.68 One strength of the transactional net margin method is that net profit indicators (e.g. return on assets, operating income to sales, and possibly other measures of net profit) are less affected by transactional

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

differences than is the case with price, as used in the CUP method. Net profit indicators also may be more tolerant to some functional differences between the controlled and uncontrolled transactions than gross profit margins. Differences in the functions performed between enterprises are often reflected in variations in operating expenses. Consequently, this may lead to a wide range of gross profit margins but still broadly similar levels of net operating profit indicators. In addition, in some countries the lack of clarity in the public data with respect to the classification of expenses in the gross or operating profits may make it difficult to evaluate the comparability of gross margins, while the use of net profit indicators may avoid the problem.

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

2.70 There are also a number of weaknesses to the transactional net margin method. The net profit indicator of a taxpayer can be influenced by some factors that would either not have an effect, or have a less substantial or direct effect, on price or gross margins between independent parties. These aspects may make accurate and reliable determinations of arm’s length net profit indicators difficult. Thus, it is important to provide some detailed guidance on establishing comparability for the transactional net margin method, as set forth in paragraphs 2.74-2.81 below.

2.71 Application of any arm’s length method requires information on uncontrolled transactions that may not be available at the time of the controlled transactions. This may make it particularly difficult for taxpayers that attempt to apply the transactional net margin method at the time of the controlled transactions (although use of multiple year data as discussed in paragraphs 3.75-3.79 may mitigate this concern). In addition, taxpayers may not have access to enough specific information on the profits attributable to comparable uncontrolled transactions to make a valid application of the

method. It also may be difficult to ascertain revenue and operating expenses related to the controlled transactions to establish the net profit indicator used as the profit measure for the transactions. Tax administrators may have more information available to them from examinations of other taxpayers. See paragraph 3.36 for a discussion of information available to tax administrators that may not be disclosed to the taxpayer, and paragraphs 3.67-3.79 for a discussion of timing issues.

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

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

B.3 Guidance for application

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

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

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

2.76 The use of net profit indicators can potentially introduce a greater element of volatility into the determination of transfer prices for two reasons. First, net profit indicators can be influenced by some factors that do not have an effect (or have a less substantial or direct effect) on gross margins and prices, because of the potential for variation of operating expenses across enterprises. Second, net profit indicators can be influenced by some of the same factors, such as competitive position, that can influence price and gross margins, but the effect of these factors may not be as readily eliminated. In the traditional transaction methods, the effect of these factors may be eliminated as a natural consequence of insisting upon greater product and function similarity. Depending on the facts and circumstances of the case and in particular on the effect of the functional differences on the cost structure and on the revenue of the potential comparables, net profit indicators can be less sensitive than gross margins to differences in the extent and complexity of functions and to differences in the level of risks (assuming the contractual allocation of risks is arm's length in accordance with Section D.1.2.1 of Chapter I). On the other hand, depending on the facts and circumstances of the case and in particular on the proportion of fixed and variable costs, the transactional net margin method may be more sensitive than the cost plus or resale price methods to differences in capacity utilisation, because differences in the levels of absorption of indirect fixed costs (e.g. fixed manufacturing costs or fixed distribution costs) would affect the net profit indicator but may not affect the gross margin or gross mark-up on costs if not reflected in price differences. See Annex I to Chapter II "Sensitivity of gross and net profit indicators".

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

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

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

2.80 The transactional net margin method may afford a practical solution to otherwise insoluble transfer pricing problems if it is used sensibly and with appropriate adjustments to account for differences of the type referred to above. The transactional net margin method should not be used unless the net profit indicators are determined from uncontrolled transactions of the same taxpayer in comparable circumstances or, where the comparable uncontrolled transactions are those of an independent enterprise, the differences between the associated enterprises and the independent enterprises that have a material effect on the net profit indicator being used

are adequately taken into account. Many countries are concerned that the safeguards established for the traditional transaction methods may be overlooked in applying the transactional net margin method. Thus where differences in the characteristics of the enterprises being compared have a material effect on the net profit indicators being used, it would not be appropriate to apply the transactional net margin method without making adjustments for such differences. The extent and reliability of those adjustments will affect the relative reliability of the analysis under the transactional net margin method. See discussion of comparability adjustments at paragraphs 3.47-3.54.

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

B.3.2 Selection of the net profit indicator

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

B.3.3 Determination of the net profit

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

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

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

2.86 Non-operating items such as interest income and expenses and income taxes should be excluded from the determination of the net profit indicator. Exceptional and extraordinary items of a non-recurring nature should generally also be excluded. This however is not always the case as there may be situations where it would be appropriate to include them, depending on the circumstances of the case and on the functions being undertaken and risks assumed by the tested party. Even where exceptional and extraordinary items are not taken into account in the determination of the net profit indicator, it may be useful to review them because they can provide valuable information for the purpose of comparability analysis (for instance by reflecting that the tested party bears a given risk).

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

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

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

2.90 Difficult comparability issues can arise where the accounting treatment of some items by potential third party comparables is unclear or does not allow reliable measurement or adjustment (see paragraph 2.81). This can be the case in particular for depreciation, amortisation, stock option and pension costs. The decision whether or not to include such items in the determination of the net profit indicator for applying the transactional net margin method will depend on a weighing of their expected effects on the appropriateness of the net profit indicator to the circumstances of the transaction and on the reliability of the comparison (see paragraph 3.50).

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

B.3.4 Weighting the net profit

2.92 The selection of the denominator should be consistent with the comparability (including functional) analysis of the controlled transaction, and in particular it should reflect the allocation of risks between the parties (provided said allocation of risks is arm's length, see Section D.1.2.1 in

Chapter I). For instance, capital-intensive activities such as certain manufacturing activities may involve significant investment risk, even in those cases where the operational risks (such as market risks or inventory risks) might be limited. Where a transactional net margin method is applied to such cases, the investment-related risks are reflected in the net profit indicator if the latter is a return on investment (e.g. return on assets or return on capital employed). Such indicator might need to be adjusted (or a different net profit indicator selected) depending on what party to the controlled transaction bears that risk, as well as on the degree of differences in risk that may be found in the taxpayer's controlled transaction and in comparables. See paragraphs 3.47-3.54 for a discussion of comparability adjustments.

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

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

2.95 The denominator should be one that is capable of being measured in a reliable and consistent manner at the level of the taxpayer's controlled transactions. In addition, the appropriate base should be one that is capable

of being measured in a reliable and consistent manner at the level of the comparable uncontrolled transactions. This in practice limits the ability to use certain indicators, as discussed at paragraph 2.105 below. Further, the taxpayer's allocation of indirect expenses to the transaction under review should be appropriate and consistent over time.

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

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

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

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

2.98 Cost-based indicators should only be used in those cases where costs are a relevant indicator of the value of the functions performed, assets used and risks assumed by the tested party. In addition, the determination of what costs should be included in the cost base should derive from a careful review of the facts and circumstances of the case. Where the net profit indicator is weighted against costs, only those costs that directly or

indirectly relate to the controlled transaction under review (or transactions aggregated in accordance to the principle at paragraphs 3.9-3.12) should be taken into account. Accordingly, an appropriate level of segmentation of a taxpayer's accounts is needed in order to exclude from the denominator costs that relate to other activities or transactions and materially affect comparability with uncontrolled transactions. Moreover, in most cases only those costs which are of an operating nature should be included in the denominator. The discussion at paragraphs 2.86-2.91 above also applies to costs as denominator.

2.99 In applying a cost-based transactional net margin method, fully loaded costs are often used, including all the direct and indirect costs attributable to the activity or transaction, together with an appropriate allocation in respect of the overheads of the business. The question can arise whether and to what extent it is acceptable at arm's length to treat a significant portion of the taxpayer's costs as pass-through costs to which no profit element is attributed (i.e. as costs which are potentially excludable from the denominator of the net profit indicator). This depends on the extent to which an independent party in comparable circumstances would agree not to earn a mark-up on part of the costs it incurs. The response should not be based on the classification of costs as "internal" or "external" costs, but rather on a comparability (including functional) analysis. See paragraph 7.34.

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

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

transactional net margin method. See paragraph 2.58 for a discussion of the same issue in relation to the cost plus method.

2.102 The use of budgeted costs can also raise a number of concerns where large differences between actual costs and budgeted costs result. Independent parties are not likely to set prices on the basis of budgeted costs without agreeing on what factors are to be taken into account in setting the budget, without having regard to how budgeted costs have compared with actual costs in previous years and without addressing how unforeseen circumstances are to be treated.

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

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

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

B.3.4.4 Other possible net profit indicators

2.105 Other net profit indicators may be appropriate depending on the facts and circumstances of the transactions. For instance, depending on the

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

B.3.5 Berry ratios

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

2.107 The selection of the appropriate financial indicator depends on the facts and circumstances of the case, see paragraph 2.82. Concerns have been expressed that Berry ratios are sometimes used in cases where they are not appropriate without the caution that is necessary in the selection and determination of any transfer pricing method and financial indicator. See paragraph 2.98 in relation to the use of cost-based indicators in general. One common difficulty in the determination of Berry ratios is that they are very sensitive to classification of costs as operating expenses or not, and therefore can pose comparability issues. In addition, the issues raised at paragraphs 2.99-2.100 above in relation to pass-through costs equally arise in the application of Berry ratios. In order for a Berry ratio to be appropriate to test the remuneration of a controlled transaction (e.g. consisting in the distribution of products), it is necessary that:

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

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

B.3.6 Other guidance

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

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

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

2.111 By way of illustration, the example of cost plus at paragraph 2.59 demonstrates the need to adjust the gross mark-up arising from transactions in order to achieve consistent and reliable comparison. Such adjustments may be made without difficulty where the relevant costs can be readily analysed. Where, however, it is known that an adjustment is required, but it is not possible to identify the particular costs for which an adjustment is required, it may, nevertheless, be possible to identify the net profit arising on the transaction and thereby ensure that a consistent measure is used. For example, if the supervisory, general, and administrative costs that are treated as part of costs of goods sold for the independent enterprises X, Y and Z cannot be identified so as to adjust the mark up in a reliable application of cost plus, it may be necessary to examine net profit indicators in the absence of more reliable comparisons.

2.112 A similar approach may be required when there are differences in functions performed by the parties being compared. Assume that the facts are the same as in the example at paragraph 2.44 except that it is the comparable independent enterprises that perform the additional function of technical support and not the associated enterprise, and that these costs are reported in the cost of goods sold but cannot be separately identified. Because of product and market differences it may not be possible to find a CUP, and a resale price method would be unreliable since the gross margin of the independent enterprises would need to be higher than that of the associated enterprise in order to reflect the additional function and to cover the unknown additional costs. In this example, it may be more reliable to examine net margins in order to assess the difference in the transfer price that would reflect the difference in function. The use of net margins in such a case needs to take account of comparability and may not be reliable if there would be a material effect on net margin as a result of the additional function or as a result of market differences.

2.113 The facts are the same as in paragraph 2.42. However, the amount of the warranty expenses incurred by Distributor A proves impossible to ascertain so that it is not possible to reliably adjust the gross profit of A to make the gross profit margin properly comparable with that of B. However, if there are no other material functional differences between A and B and the net profit of A relative to its sales is known, it might be possible to apply the transactional net margin method to B by comparing the margin relative to A's sales to net profits with the margin calculated on the same basis for B.

C. Transactional profit split method

The guidance contained in this section and in Annexes II and III to Chapter II are expected to be revised to include the conclusions of the ongoing work of Working Party No. 6 on the application of profit split methods. This work, mandated by Action 10 of the BEPS Action Plan, is aimed at clarifying the application of transfer pricing methods, in particular the transactional profit split method, in the context of global value chains.

C.1 In general

2.114 The transactional profit split method seeks to eliminate the effect on profits of special conditions made or imposed in a controlled transaction (or in controlled transactions that are appropriate to aggregate under the principles of paragraphs 3.9-3.12) by determining the division of profits that independent enterprises would have expected to realise from engaging in the transaction or transactions. The transactional profit split method first identifies the profits to be split for the associated enterprises from the controlled transactions in which the associated enterprises are engaged (the “combined profits”). References to “profits” should be taken as applying equally to losses. See paragraphs 2.130-2.137 for a discussion of how to measure the profits to be split. It then splits those combined profits between the associated enterprises on an economically valid basis that approximates the division of profits that would have been anticipated and reflected in an agreement made at arm’s length. See paragraphs 2.138-2.151 for a discussion of how to split the combined profits.

C.2 Strengths and weaknesses

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

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

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

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

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

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

2.119 A further strength of the transactional profit split method is that it is less likely that either party to the controlled transaction will be left with an

extreme and improbable profit result, since both parties to the transaction are evaluated. This aspect can be particularly important when analysing the contributions by the parties in respect of the intangible property employed in the controlled transactions. This two-sided approach may also be used to achieve a division of the profits from economies of scale or other joint efficiencies that satisfies both the taxpayer and tax administrations.

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

C.3 Guidance for application

C.3.1 In general

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

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

- Be consistent with the functional analysis of the controlled transaction under review, and in particular reflect the allocation of risks among the parties,

- Be consistent with the determination of the combined profits to be split and of the splitting factors which would have been agreed between independent parties,
- Be consistent with the type of profit split approach (e.g. contribution analysis, residual analysis, or other; *ex ante* or *ex post* approach, as discussed at paragraphs 2.124-2.151 below), and
- Be capable of being measured in a reliable manner.

2.123 In addition,

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

C.3.2 Various approaches for splitting the profits

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

C.3.2.1 Contribution analysis

2.125 Under a contribution analysis, the combined profits, which are the total profits from the controlled transactions under examination, would be

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

2.126 It can be difficult to determine the relative value of the contribution that each of the associated enterprises makes to the controlled transactions, and the approach will often depend on the facts and circumstances of each case. The determination might be made by comparing the nature and degree of each party's contribution of differing types (for example, provision of services, development expenses incurred, capital invested) and assigning a percentage based upon the relative comparison and external market data. See paragraphs 2.138-2.151 for a discussion of how to split the combined profits.

C.3.2.2 Residual analyses³

2.127 A residual analysis divides the combined profits from the controlled transactions under examination in two stages. In the first stage, each participant is allocated an arm's length remuneration for its non-unique contributions in relation to the controlled transactions in which it is engaged. Ordinarily this initial remuneration would be determined by applying one of the traditional transaction methods or a transactional net margin method, by reference to the remuneration of comparable transactions between independent enterprises. Thus, it would generally not account for the return that would be generated by any unique and valuable contribution by the participants. In the second stage, any residual profit (or loss) remaining after the first stage division would be allocated among the parties based on an analysis of the facts and circumstances, following the guidance as described at paragraphs 2.138-2.151 for splitting the combined profits.

2.128 An alternative approach to how to apply a residual analysis could seek to replicate the outcome of bargaining between independent enterprises in the free market. In this context, in the first stage, the initial remuneration provided to each participant would correspond to the lowest price an

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

independent seller reasonably would accept in the circumstances and the highest price that the buyer would be reasonably willing to pay. Any discrepancy between these two figures could result in the residual profit over which independent enterprises would bargain. In the second stage, the residual analysis therefore could divide this pool of profit based on an analysis of any factors relevant to the associated enterprises that would indicate how independent enterprises might have split the difference between the seller's minimum price and the buyer's maximum price.

2.129 In some cases an analysis could be performed, perhaps as part of a residual profit split or as a method of splitting profits in its own right, by taking into account the discounted cash flow to the parties to the controlled transactions over the anticipated life of the business. One of the situations in which this may be an effective method could be where a start-up is involved, cash flow projections were carried out as part of assessing the viability of the project, and capital investment and sales could be estimated with a reasonable degree of certainty. However, the reliability of such an approach will depend on the use of an appropriate discount rate, which should be based on market benchmarks. In this regard, it should be noted that industry-wide risk premiums used to calculate the discount do not distinguish between particular companies let alone segments of businesses, and estimates of the relative timing of receipts can be problematic. Such an approach, therefore, would require considerable caution and should be supplemented where possible by information derived from other methods.

C.3.3 Determining the combined profits to be split

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

2.131 In order to determine the combined profits to be split, the accounts of the parties to the transaction to which a transactional profit split is applied need to be put on a common basis as to accounting practice and currency, and then combined. Because accounting standards can have significant effects on the determination of the profits to be split, accounting standards should be selected in advance of applying the method and applied consistently over the lifetime of the arrangement. See paragraphs 2.121-

2.123 for general guidance on the consistency of the determination of the combined profits to be split.

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

C.3.3.1 *Actual or projected profits*

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

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

2.135 In using the transactional profit split method to establish the conditions of controlled transactions, the associated enterprises would seek to achieve the division of profit that independent enterprises would have realized. The evaluation of the conditions of the controlled transactions of associated enterprises using a transactional profit split method will be easiest for a tax administration where the associated enterprises have originally determined such conditions on the same basis. The evaluation may then begin on the same basis to verify whether the division of actual profits is in accordance with the arm's length principle.

2.136 Where the associated enterprises have determined the conditions in their controlled transactions on a basis other than the transactional profit split method, the tax administration would evaluate such conditions on the basis of the actual profit experience of the enterprise. However, care would

need to be exercised to ensure that the application of a transactional profit split method is performed in a context that is similar to what the associated enterprises would have experienced, i.e. on the basis of information known or reasonably foreseeable by the associated enterprises at the time the transactions were entered into, in order to avoid the use of hindsight. See paragraphs 2.12 and 3.74.

C.3.3.2 Different measures of profits⁴

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

C.3.4 How to split the combined profits

C.3.4.1 In general

2.138 The relevance of comparable uncontrolled transactions or internal data and the criteria used to achieve an arm's length division of the profits depend on the facts and circumstances of the case. It is therefore not desirable to establish a prescriptive list of criteria or allocation keys. See paragraphs 2.121-2.123 for general guidance on the consistency of the

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

determination of the splitting factors. In addition, the criteria or allocation keys used to split the profit should:

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

C.3.4.2 Reliance on data from comparable uncontrolled transactions

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

C.3.4.3 Allocation keys

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

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

storage, floor area of retail points, etc. may be appropriate depending on the facts and circumstances of the transactions.

Asset-based allocation keys

2.142 Asset-based or capital-based allocation keys can be used where there is a strong correlation between tangible or intangible assets or capital employed and creation of value in the context of the controlled transaction. See paragraph 2.151 for a brief discussion of splitting the combined profits by reference to capital employed. In order for an allocation key to be meaningful, it should be applied consistently to all the parties to the transaction. See paragraph 2.104 for a discussion of comparability issues in relation to asset valuation in the context of the transactional net margin method, which is also valid in the context of the transactional profit split method.

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

Cost-based allocation keys

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

2.145 Cost-based allocation keys have the advantage of simplicity. It is however not always the case that a strong correlation exists between relative expenses and relative value, as discussed in paragraph 6.142. One possible issue with cost-based allocation keys is that they can be very sensitive to accounting classification of costs. It is therefore necessary to clearly identify in advance what costs will be taken into account in the determination of the allocation key and to determine the allocation key consistently among the parties.

Timing issues

2.146 Another important issue is the determination of the relevant period of time from which the elements of determination of the allocation key (e.g. assets, costs, or others) should be taken into account. A difficulty arises because there can be a time lag between the time when expenses are incurred and the time when value is created, and it is sometimes difficult to decide which period's expenses should be used. For example, in the case of a cost-based allocation key, using the expenditure on a single-year basis may be suitable for some cases, while in some other cases it may be more suitable to use accumulated expenditure (net of depreciation or amortization, where appropriate in the circumstances) incurred in the previous as well as the current years. Depending on the facts and circumstances of the case, this determination may have a significant effect on the allocation of profits amongst the parties. As noted at paragraphs 2.122-2.123 above, the selection of the allocation key should be appropriate to the particular circumstances of the case and provide a reliable approximation of the division of profits that would have been agreed between independent parties.

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

2.147 Where comparable uncontrolled transactions of sufficient reliability are lacking to support the division of the combined profits, consideration should be given to internal data, which may provide a reliable means of establishing or testing the arm's length nature of the division of profits. The types of such internal data that are relevant will depend on the facts and circumstances of the case and should satisfy the conditions outlined in this Section and in particular at paragraphs 2.122-2.123 and 2.138. They will frequently be extracted from the taxpayers' cost accounting or financial accounting.

2.148 For instance, where an asset-based allocation key is used, it may be based on data extracted from the balance sheets of the parties to the transaction. It will often be the case that not all the assets of the taxpayers relate to the transaction at hand and that accordingly some analytical work is

needed for the taxpayer to draw a “transactional” balance sheet that will be used for the application of the transactional profit split method. Similarly, where cost-based allocation keys are used that are based on data extracted from the taxpayers’ profit and loss accounts, it may be necessary to draw transactional accounts that identify those expenses that are related to the controlled transaction at hand and those that should be excluded from the determination of the allocation key. The type of expenditure that is taken into account (e.g. salaries, depreciation, etc.) as well as the criteria used to determine whether a given expense is related to the transaction at hand or is rather related to other transactions of the taxpayer (e.g. to other lines of products not subject to this profit split determination) should be applied consistently to all the parties to the transaction. See also paragraph 2.104 for a discussion of valuation of assets in the context of the transactional net margin method where the net profit is weighted to assets, which is also relevant to the valuation of assets in the context of a transactional profit split where an asset-based allocation key is used.

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

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

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

functional analysis and that should be taken into account in a transactional profit split.

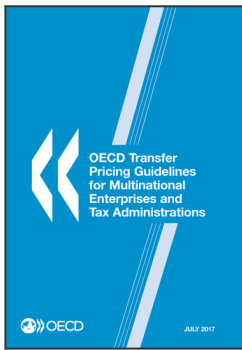
D. Conclusions on transactional profit methods

2.152 Paragraphs 2.1-2.12 provide guidance on the selection of the most appropriate transfer pricing method to the circumstances of the case.

2.153 As discussed in these Guidelines, there are concerns regarding the use of the transactional net margin method, in particular that it is sometimes applied without adequately taking into account the relevant differences between the controlled and uncontrolled transactions being compared. Many countries are concerned that the safeguards established for the traditional transaction methods may be overlooked in applying the transactional net margin method. Thus, where differences in the characteristics of the transactions being compared have a material effect on the net profit indicators being used, it would not be appropriate to apply the transactional net margin method without making adjustments for such differences. See paragraphs 2.74-2.81 (the comparability standard to be applied to the transactional net margin method).

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

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



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