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 in 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 in 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 in 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 in 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 in 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 USD 80 per ton to an associated enterprise in its MNE group, and at the same time sells 500 tons of the same product for USD 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 equalised across different activities. In contrast, prices for different products would tend to equalise 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 realise 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 jurisdictions 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 jurisdictions, 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-emphasise 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 2.119. 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 weaknesses[1]

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 differences than is

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

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 jurisdictions 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 in 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 in 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 jurisdictions 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 in 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 in 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 in 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 in 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 in 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 in 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 in 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 in 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 in 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 in 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

C.1. General

2.114. The transactional profit split method seeks to establish arm's length outcomes or test reported outcomes for controlled transactions in order to approximate the results that would have been achieved between independent enterprises engaging in a comparable transaction or transactions. The method first identifies the profits to be split from the controlled transactions – the relevant profits – and then splits them between the associated enterprises on an economically valid basis that approximates the division of profits that would have been agreed at arm's length. As is the case with all transfer pricing methods, the aim is to ensure that profits of the associated enterprises are aligned with the value of their contributions and the compensation which would have been agreed in comparable transactions between independent enterprises for those contributions. The transactional profit split method is particularly useful when the compensation to the associated enterprises can be more reliably valued by reference to the relative shares of their contributions to the profits arising in relation to the transaction(s) than by a more direct estimation of the value of those contributions.

2.115. References to "profits" in this section should generally be taken as applying equally to losses. That is, where a transactional profit split method is determined to be the most appropriate method, it should generally also apply, and apply in the same way, regardless of whether the transaction(s) result in a relevant profit or loss. Asymmetrical splits of profits and losses (i.e. where the parties apply different considerations depending on the results of the transaction) might be arm's length, but should be used with caution and appropriately documented.

C.2. When is a transactional profit split method likely to be the most appropriate method?

2.116. As is noted in paragraph 2.2, the selection of a transfer pricing method always aims at finding the most appropriate method for a particular case, taking into account the respective strengths and weaknesses of each method, its appropriateness in view of the nature of the accurately delineated controlled transaction, the availability of reliable information (in particular on uncontrolled comparables) needed for application, and the degree of comparability between the controlled and uncontrolled transactions. See also paragraphs 2.4 to 2.7.

2.117. Guidance on how to determine whether the transactional profit split method is likely to be the most appropriate method is set out below, including the identification of certain features of a transaction which may be relevant. However it is important to note that there is no prescriptive rule for establishing when a particular transfer pricing method is the most appropriate method.

2.118. While there is no requirement in these Guidelines to undertake exhaustive analysis or testing of every method in each case, the selection of the most appropriate method should take into account the *relative* appropriateness and reliability of the selected method as compared to other methods which could be used.

C.2.1. Strengths and weaknesses of the transactional profit split method

2.119. The main strength of the transactional profit split method is that it can offer a solution for cases where both parties to a transaction make unique and valuable contributions (e.g. contribute unique and valuable intangibles) to the transaction. In such a case independent parties might effectively price the transaction in proportion to their respective contributions, making a two-sided method more appropriate. Furthermore, since those contributions are unique and valuable there will be no reliable comparables information which could be used to price the entirety of the transaction in a more reliable way, through the application of another method. In such cases, the allocation of profits under the transactional profit split method may be based on the contributions made by the associated enterprises, by reference to the relative values of their respective functions, assets and risks. See Section C.2.2 below on the nature of the transaction.

2.120. The transactional profit split method can also provide a solution for highly integrated operations in cases for which a one-sided method would not be appropriate. See Section C.2.2.2, below.

2.121. Another strength of the transactional profit split method is that it can offer flexibility by taking into account specific, possibly unique, facts

and circumstances of the associated enterprises that may not be present in independent enterprises. Moreover, where there is a high degree of uncertainty for each of the parties in relation to a transaction, for example in transactions involving the shared assumption of economically significant risks by all parties (or the separate assumption of closely related economically significant risks), the flexibility of the transactional profit split method can allow for the determination of arm's length profits for each party that vary with the actual outcomes of the risks associated with the transaction.

2.122. A further strength of the transactional profit split method is that all relevant parties to the transaction are directly evaluated as part of the pricing of the transaction, that is, the contributions of each party to the transaction are specifically identified and their relative values measured in order to determine an arm's length compensation for each party in relation to the transaction.

2.123. 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 the detailed information required to apply a transactional profit split method reliably. It may be difficult to measure the relevant revenue and costs for all the associated enterprises participating in the controlled transactions, which could 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. Identifying the appropriate profit splitting factors can also be challenging. Given the necessity of applying judgement in determining each of the parameters for the application of the transactional profit split method, it will be particularly important to document how the method has been applied, including the determination of the relevant profits to be split, and how the profit splitting factors were arrived at. See Sections C.4 and C.5.

2.124. It is sometimes argued that a transactional profit split method is rarely used among independent enterprises, and thus its application in controlled transactions should be similarly rare. Where such a method is determined to be the most appropriate, this should not be a factor since transfer pricing methods are not necessarily intended to replicate arm's length behaviour, but rather to serve as a means of establishing and/or verifying arm's length outcomes for controlled transactions. That said, where there is evidence that independent parties in comparable transactions apply a profit split method among themselves, such evidence should be considered in determining

whether a transactional profit split method is the most appropriate method for the controlled transactions. See paragraph 2.129.

C.2.2. Nature of the accurately delineated transaction

2.125. The accurate delineation of the actual transaction will be important in determining whether a transactional profit split is potentially applicable. This process should have regard to the commercial and financial relations between the associated enterprises, including an analysis of what each party to the transaction does, and the context in which the controlled transactions take place. That is, the accurate delineation of a transaction requires a two-sided analysis (or a multi-sided analysis of the contributions of more than two associated enterprises, where necessary) irrespective of which transfer pricing method is ultimately found to be the most appropriate. (See Section D.1, and in particularly Section D.1.2 of Chapter I of these Guidelines.)

2.126. The existence of unique and valuable contributions by each party to the controlled transaction is perhaps the clearest indicator that a transactional profit split may be appropriate. The context of the transaction, including the industry in which it occurs and the factors affecting business performance in that sector can be particularly relevant to evaluating the contributions of the parties and whether such contributions are unique and valuable. Depending on the facts of the case, other indicators that the transactional profit split may be the most appropriate method could include a high level of integration in the business operations to which the transactions relate and /or the shared assumption of economically significant risks (or the separate assumption of closely related economically significant risks) by the parties to the transactions. It is important to note that the indicators are not mutually exclusive and on the contrary may often be found together in a single case.

2.127. At the other end of the spectrum, where the accurate delineation of the transaction determines that one party to the transaction performs only simple functions, does not assume economically significant risks in relation to the transaction and does not otherwise make any contribution which is unique and valuable, a transactional profit split method typically would not be appropriate since a share of profits (which may be impacted by the playing out of the economically significant risks) would be unlikely to represent an arm's length outcome for such contributions or risk assumption.

2.128. A lack of closely comparable, uncontrolled transactions which would otherwise be used to benchmark an arm's length return for the party performing the less complex functions should not *per se* lead to a conclusion that the transactional profit split is the most appropriate method. Depending on the facts of the case, an appropriate method using uncontrolled transactions that are sufficiently comparable, but not identical to the

controlled transaction is likely to be more reliable than an inappropriate use of the transactional profit split method. See paragraphs 3.38-3.39 for a discussion of limitations in available comparables. See also Section C.2.3.

2.129. It may also be relevant to consider industry practices. For instance, if information is available that independent parties do commonly use profit splitting approaches in similar situations, careful consideration should be given to whether the transactional profit split method may be the most appropriate method for the controlled transactions. Such industry practices may be a pointer to the fact that each party makes unique and valuable contributions, and/or that the parties are highly inter-dependent upon each other. Conversely, if independent parties engaged in comparable transactions are found to make use of other pricing methods, this should also be taken into account in determining the most appropriate transfer pricing method.

C.2.2.1. Unique and valuable contributions by each of the parties to the transaction

2.130. Contributions (for instance functions performed, or assets used or contributed) will be "unique and valuable" in cases where (i) they are not comparable to contributions made by uncontrolled parties in comparable circumstances, and (ii) they represent a key source of actual or potential economic benefits in the business operations. The two factors are often linked: comparables for such contributions are seldom found because they are a key source of economic advantage. It may be the case that in these situations, the risks associated with the respective unique and valuable contributions cannot be controlled by the other party or parties. This may impact the assumption of risk under the accurate delineation of the actual transaction. For example, the developer and manufacturer of a key component of a product together with the developer and manufacturer of another key component that together with the first component, form the ready-to-sell product, may both make unique and valuable contributions in terms of functions and intangibles that represent a key source of economic benefits. (See also paragraphs 6.50 to 6.58 and 6.133.) In practice, neither of them may be able to control the development risk in relation to the product as a whole, but instead they together control the development risks and share in the relevant profits resulting from their contributions. The principles of this section are illustrated by Examples 1, 2, 3 and 4 in Annex II to Chapter II of these Guidelines.

Transactions involving unique and valuable intangibles

2.131. Where each party to the transaction legally owns unique and valuable intangibles that are relevant to the transaction, it will also be necessary to consider whether, under the accurate delineation of the transaction, they

each assume the economically significant risks relating to those intangibles, e.g. risks related to development, obsolescence, infringement, product liability and exploitation (see paragraphs 6.65 to 6.68).

2.132. As set out in paragraphs 6.148 to 6.149 and 6.152, in some cases, the transactional profit split method may be the most appropriate method for a transfer of fully developed intangibles (including rights in intangibles) where it is not possible to identify reliable comparable uncontrolled transactions. The transactional profit split method may also be appropriate for transfers of partially developed intangibles. Example 5 in Annex II to Chapter II provides an illustration. See paragraphs 6.150 to 6.151. Where the intangibles transferred are hard-to-value intangibles, the provisions of Section D.4 of Chapter VI should be considered.

C.2.2.2. Highly integrated business operations

2.133. Although most MNE groups are integrated to some extent, a particularly high degree of integration in certain business operations is an indicator for the consideration of the transactional profit split method. A high degree of integration means that the way in which one party to the transaction performs functions, uses assets and assumes risks is interlinked with, and cannot reliably be evaluated in isolation from, the way in which another party to the transaction performs functions, uses assets and assumes risks. In contrast, many instances of integration within an MNE result in situations in which the contribution of at least one party to the transaction can in fact be reliably evaluated by reference to comparable uncontrolled transactions. For example, where complementary but discrete activities are undertaken by the entities, it may be the case that it is possible to find reliable comparables since the functions, assets and risks involved in each discrete stage may be comparable to those in uncontrolled arrangements. This needs to be borne in mind in considering which transfer pricing method is the most appropriate in a particular case. Examples 6, 7 and 8 in Annex II to Chapter II illustrate the principles of this section.

2.134. In some cases the parties may perform functions jointly, use assets jointly and/or share assumption of risks to such an extent that it is impossible to evaluate their respective contributions in isolation from those of others. As an example, the transactional profit split method can be applied to the global trading of financial instruments by associated enterprises. See in Part III, Section C of the Report on the Attribution of Profits to Permanent Establishments.[2]

2. See *Report on the Attribution of Profits to Permanent Establishments* (OECD, 2010).

2.135. Another example may be where the integration between the parties takes the form of a high degree of inter-dependency. For instance, profit split approaches may be used by independent enterprises engaged in long-term arrangements where each party has made a significant contribution (e.g. of an asset) whose value depends on the counterparty to the arrangement. In these kinds of cases, where each party makes such a contribution, and is dependent on the other party (or where the value of the contribution(s) of one party depends to a significant degree on the contribution(s) of the other party), some form of flexible pricing that takes into account, and varies with, the outcome of the risks assumed by each party arising from its dependence on the other party may be observed.

2.136. Where business operations are highly integrated, the extent to which the parties share the assumption of the same economically significant risks or separately assume closely related economically significant risks will be relevant to the determination of the most appropriate method and, if a transactional profit split is considered the most appropriate method, how it should be applied; in particular whether a split of actual profits or of anticipated profits should be used. See Section C.4.1.

2.137. Where a party contributes to the control of economically significant risk, but that risk is assumed by the other party to the transaction, this may, in some cases, demonstrate that it is appropriate for the first party to share in the potential upside and downside associated with that risk, commensurate with its contribution to control. See paragraph 1.105. However, the mere fact that an entity performs control functions in relation to a risk will not necessarily lead to the conclusion that the transactional profit split is the most appropriate method in the case.

2.138. Where the contributions are highly inter-related or inter-dependent upon each other, the evaluation of the respective contributions of the parties may need to be done holistically. That is, a high degree of integration may also affect whether contributions by the enterprises are considered to be unique and valuable. For instance, a unique contribution by one party may have a significantly greater value when considered in combination with the particular unique contribution of the other party. Paragraphs 6.93-6.94 discuss this issue in relation to the combination of intangibles. See also Example 9 in Annex II to Chapter II.

C.2.2.3. Shared assumption of economically significant risks, separate assumption of closely related risks

2.139. A transactional profit split may be found to be the most appropriate method where, according to the accurately delineated transaction, each party to the controlled transaction shares the assumption of one or more

of the economically significant risks in relation to that transaction (see paragraph 1.95).

2.140. A transactional profit split may also be found to be the most appropriate method where, according to the accurately delineated transaction, the various economically significant risks in relation to the transaction are separately assumed by the parties, but those risks are so closely inter-related and/or correlated that the playing out of the risks of each party cannot reliably be isolated. See Example 10 in Annex II to Chapter II.

2.141. The relevance of this factor as an indicator for the transactional profit split method will depend in large measure on the extent to which the risks concerned are economically significant such that a share of relevant profits would be warranted for each party. The economic significance of the risks should be analysed in relation to their importance to the actual or anticipated relevant profits from the controlled transaction(s), rather than in respect of their importance to any one of the associated enterprises whose business operations may extend beyond those covered by the relevant profits.

2.142. If each party shares the assumption of economically significant risks or separately assumes inter-related, economically significant risks, and a transactional profit split is considered to be the most appropriate method, it is likely that a split of actual profits, rather than anticipated profits, will be warranted since those actual profits, i.e. the actual relevant profits to be split, will reflect the playing out of the risks of each party. Conversely, a profit split of anticipated profits will tend to concentrate the playing out of economically significant risks on one party. That is, the transfer pricing outcome – a sharing of actual or anticipated profits – should align with the accurate delineation of the transaction. See Section C.4.1 below on splits of actual and anticipated profits.

C.2.3. Availability of reliable information

2.143. In general, it will tend to be the case that the presence of factors indicating that a transactional profit split is the most appropriate method will correspond to an absence of factors indicating that an alternative transfer pricing method – one which relies entirely on comparables – is the most appropriate method, determined in accordance with paragraph 2.2 of these Guidelines. Put another way, if information on reliable comparable uncontrolled transactions is available to price the transaction in its entirety, it is less likely that the transactional profit split method will be the most appropriate method. However, a lack of comparables alone is insufficient to warrant the use of a transactional profit split. See paragraph 2.128.

2.144. While the transactional profit split method can be applied in cases where there are no uncontrolled comparables, information from transactions between

independent parties may still be relevant to the application of the method, for example to guide the splitting of relevant profits (see Section C.3.1.1), or where a residual analysis approach is used (see Section C.3.1.2).

C.2.4. Conclusions

2.145. This section has described certain characteristics of the transactional profit split method and provided a number of potential indicators as to when it may be found to be the most appropriate method, as well as a number of factors which may point in the opposite direction. The guidance in this regard does not seek to be comprehensive, nor is it prescriptive. The presence or absence of one or more of the indicators described in this section will not necessarily lead to the conclusion that the transactional profit split will (or will not) be the most appropriate method in a particular case. Each case needs to be analysed on its own facts, and it will be important to consider the relative merits and shortcomings of available transfer pricing methods.

C.3. Guidance for application – in general

2.146. 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 facts and 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.

2.147. Under the transactional profit split method, the relevant 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 relevant profits to be split and of the profit splitting factors should be:

- consistent with the functional analysis of the controlled transaction under review, and in particular reflect the assumption of the economically significant risks by the parties, and
- capable of being measured in a reliable manner.

2.148. In addition,

- If the transactional profit split method is used to set transfer pricing in controlled transactions at the outset, it would be reasonable to expect the life-time of the arrangement and the criteria or profit splitting factors to be agreed in advance of the transaction,
- The person using the transactional profit split method (taxpayer or tax administration) should be prepared to explain why it is regarded

as the most appropriate method in the circumstances of the case, as well as the way it is implemented, and in particular the criteria or profit splitting factors used to split the relevant profits, and

- The determination of the relevant profits to be split and of the profit splitting factors should generally be used consistently over the life-time of the arrangement, including during loss years, unless the rationale for using differing relevant profits or profit splitting factors over time is supported by the facts and circumstances and is documented.

C.3.1. Approaches to splitting profits

2.149. There are a number of approaches to the application of the transactional profit split method, depending on the characteristics of the controlled transactions, and the information available. As has been described above, the method seeks to split the relevant profits from controlled transactions on an economically valid basis, in order to approximate the results that would have been achieved between independent enterprises in comparable circumstances. This may be done by considering the relative contributions of each party (a "contribution analysis"). Where the transactional profit split method is the most appropriate method but at least one party also makes some less complex contributions which are capable of being benchmarked by reference to comparable, uncontrolled transactions, a two-stage "residual analysis" may be appropriate.

C.3.1.1. Contribution analysis

2.150. Under a contribution analysis, the relevant profits, which are the total profits from the controlled transactions under examination, are divided between the associated enterprises in order to arrive at a reasonable approximation of the division that independent enterprises would have achieved from engaging in comparable transactions. This division can be supported by comparables data where available. In the absence thereof, it should be based on the relative value of the contributions by each of the associated enterprises participating in the controlled transactions, determined using information internal to the MNE group, as a proxy for the division that independent enterprises would have achieved (see Section C.5.2). In cases where the relative value of the contributions can be measured, it may not be necessary to estimate the actual market value of each party's contributions.

2.151. It can be difficult to determine the relative value of the contribution that each of the associated enterprises makes to the relevant profits, and the approach will 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, assets used or contributed, capital invested) and assigning a percentage based upon the relative comparison and external market data. See Section C.5 for a discussion of how to split the relevant profits.

C.3.1.2. Residual analysis

2.152. Where the contributions of the parties are such that some can be reliably valued by reference to a one-sided method and benchmarked using comparables, while others cannot, the application of a residual analysis may be appropriate. A residual analysis divides the relevant profits from the controlled transactions under examination into two categories. In the first category are profits attributable to contributions which can be reliably benchmarked: typically less complex contributions for which reliable comparables can be found. Ordinarily this initial remuneration would be determined by applying one of the traditional transaction methods or a transactional net margin method to identify the remuneration of comparable transactions between independent enterprises. Thus, it would generally not account for the return that would be generated by a second category of contributions which may be unique and valuable**,** and/or are attributable to a high level of integration or the shared assumption of economically significant risks. Typically, the allocation of the residual profit among the parties will be based on the relative value of the second category of contributions of the parties in the same way as in the application of the contribution analysis outlined above and in accordance with the guidance as described in Section C.5.

2.153. Example 11 in Annex II to Chapter II illustrates the application of a residual analysis under a transactional profit split method.

C.4. Guidance for application – Determining the profits to be split

2.154. The relevant profits to be split under the transactional profit split method are those of the associated enterprises arising as a result of the controlled transactions under review. It is essential to identify the level of aggregation, see paragraphs 3.9-3.12. In determining the relevant profits, it is therefore essential to first identify and accurately delineate the transactions to be covered by the transactional profit split method, and from this identify the relevant income and expense amounts for each party in relation to those transactions. See Section C.4.2, below. Example 12 in Annex II to Chapter II of these Guidelines illustrates the principles of this section.

2.155. Where the relevant profits to be split are comprised of profits of two or more associated enterprises, the relevant financial data 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, in cases where the taxpayer chooses to use the transactional profit split method, be selected in advance of applying the method and applied consistently over the lifetime of the arrangement. Differences in accounting standards may affect the timing of revenue recognition as well as the treatment of expenses in arriving at profits. Material differences between the accounting standards used by the parties should be identified and aligned.

2.156. Financial accounting may provide the starting point for determining the profit to be split in the absence of harmonised 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.

2.157. However, except in circumstances where the total activities of each of the parties are the subject of the profit split, the financial data will need to be segregated and allocations made in accordance with the accurately delineated transaction(s) so that the profits relating to the combined contributions made by the parties are identified. For example, a product supplier in a profit split with an associated enterprise engaged in European marketing and distribution would need to identify the profits arising from its production of goods for the European market, and exclude the profits arising from the production of goods for other markets. The exercise may be relatively simple if the same goods are supplied to all markets, but will be more complex if different goods with different production costs or with different embedded technology, for example, are supplied to different markets. Similarly, if the associated enterprise engaged in European marketing and distribution buys products from other sources, it will need to segregate its financial data in a way that reflects the revenues, costs, and profits relating to the goods purchased from the associated product supplier in the profit split. Experience suggests that this initial stage in performing a profit split can in some circumstances be extremely complex, and the method of identifying the profits relevant to the transaction and any assumptions made in doing so need to be documented.

C.4.1. Transactional profit splits of actual or anticipated profits

2.158. The determination of the profits to be split, including whether those profits are actual profits or anticipated profits, or some combination thereof, should be aligned with the accurately delineated transaction. Example 13 in Annex II to Chapter II illustrates the principles of this section.

2.159. Where the transactional profit split method is found to be the most appropriate, the splitting of actual profits, i.e. profits which have been

affected by the playing out of economically significant risks, would only be appropriate where the accurate delineation of the transaction shows that the parties either share the assumption of the same economically significant risks associated with the business opportunity or separately assume closely related, economically significant risks associated with the business opportunity and consequently should share in the resulting profits or losses. These kinds of risk assumption may occur in scenarios where the business operations are highly integrated and/or each party makes unique and valuable contributions.

2.160. Alternatively, if the transactional profit split is found to be the most appropriate method (e.g. because each party to the transaction makes unique and valuable contributions) but one of the parties does not share in the assumption of the economically significant risks which might play out after entering into the transaction, a split of anticipated profits would be more appropriate. See scenario 1 of Example 13 in Annex II to Chapter II of this guidance.

2.161. In any application of a transactional profit split, care should be exercised to ensure that the method is applied without hindsight. See paragraph 3.74. That is, irrespective of whether a transactional profit split of anticipated or actual profits is used, unless there are major unforeseen developments which would have resulted in a renegotiation of the agreement had it occurred between independent parties, the basis upon which those profits are to be split between the associated enterprises, including the profit splitting factors, the way in which relevant profits are calculated, and any adjustments or contingencies, must be determined on the basis of information known or reasonably foreseeable by the parties at the time the transactions were entered into. This is so notwithstanding the fact that in many cases, the actual calculations can necessarily only be performed some time afterwards, where, for example they apply profit splitting factors determined at the outset to the actual profits. Additionally, it should be remembered that the starting point in the accurate delineation of any transaction will generally be the written contracts which may reflect the intention of the parties at the time the contract was concluded. See paragraph 1.42.

C.4.2. Different measures of profits

2.162. Most commonly, the relevant profits to be split under the transactional profit split method are operating profits. Applying the transactional profit split method in this manner ensures that both income and expenses of the MNE are attributed to the relevant associated enterprise on a consistent basis. However, depending on the accurate delineation of the transaction, it may be appropriate to split a different measure of profits such as gross profits, and then deduct the expenses incurred by or attributable to each relevant enterprise (excluding expenses already taken into account). In such cases,

care must be taken to ensure that the expenses incurred by or attributable to each enterprise are consistent with the accurate delineation of the transaction, particularly the activities and risks undertaken by each party, and that the allocation of profits is likewise consistent with the contributions of the parties.

2.163. That is, the measure of profits to be split will depend on the accurate delineation of the transaction. For instance, if the accurate delineation of the transaction determines that the parties share the assumption of not only market risk, which affects the volume of sales and prices charged, but also risks associated with producing or otherwise acquiring goods and services, which affect the level of gross profit, it would be most appropriate to use gross profits as the basis of the split. In such a scenario, the parties may have integrated or joint functions and assets relating to the production or acquisition of goods and services. If the accurate delineation of the transaction determines that the parties share the assumption of, in addition to market and production risks, a further range of risks that affect the level of operating expenses that may include investment in intangibles, it would be most appropriate to use operating profits as the basis of the split. In this scenario, the parties may have integrated or joint functions relating to the entire value chain.

2.164. For example, two associated enterprises, each with its own manufacturing specialisation and unique and valuable intangibles, agree to contribute the intangibles to produce innovative, complex products. The accurate delineation of the transaction determines that the enterprises in this example share the assumption of risks associated with the success or otherwise of the products in the marketplace. However, they do not share the assumption of risks associated with their selling and other expenses, which are largely unintegrated. Using a profit split based on combined operating profits after all expenses of both parties would have the potential result of sharing the consequences of risks that are assumed by only one of the parties. In such cases, a splitting of gross profits may be more appropriate and reliable since this level of profits captures the outcomes of market and production activities that the parties share together with the assumption of associated risks. Similarly, in the case of associated enterprises that engage in highly integrated worldwide trading operations, if the accurate delineation of the actual transaction determines that the shared assumption of risks and level of integration does not extend to operating costs, it may be appropriate to split the gross profits from each trading activity, and then deduct from the resulting share of the overall gross profits allocated to each enterprise its own operating expenses incurred.

2.165. Example 14 in Annex II to Chapter II illustrates the principles of this section.

C.5. Splitting the profits

2.166. Profits should be split on an economically valid basis that reflects the relative contributions of the parties to the transaction and thus approximates the division of profits that would have obtained at arm's length. The relevance of comparable uncontrolled transactions or internal data (see Section C.5.2) 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 profit splitting factors. See paragraphs 2.146-2.148 for general guidance on the consistency of the determination of the splitting factors. In addition, the criteria or splitting factors used to split the profit should be:

- 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),
- verifiable, and
- supported by comparables data, internal data, or both.

2.167. One possible approach is to split the relevant profits based on the division of profits that actually is observed in 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.

2.168. However, it can be difficult to find reliable comparables data that can be used in this manner. Nevertheless, external market data can be relevant in the profit split analysis to assess the value of contributions that each associated enterprise makes to the transactions. In effect, the assumption is that independent parties would have split relevant profits in proportion to the value of their respective contributions to the generation of profit in the transaction. Thus, 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 relative contributions of the parties, as measured by their functions, assets used and risks assumed.

C.5.1. Profit splitting factors

2.169. As noted above, arm's length parties can be assumed to split profits on the basis of their relative contributions to the creation of those profits. The division of the relevant profits under the transactional profit split method is generally achieved using one or more profit splitting factors. The functional analysis and an analysis of the context in which the transactions take place (e.g. the industry and environment) are essential to the process of determining the relevant factors to use in splitting profits, including determining the weighting of applicable profit splitting factors, in cases where more than one factor is used. The determination of appropriate profit splitting factor(s) should reflect the key contributions to value in relation to the transaction. Examples 15 and 16 in Annex II to Chapter II of these Guidelines illustrate the principles of this section.

2.170. Depending on the facts and circumstances of the case, the factor 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 contributions or other possible factors as discussed below) which could be calculated on the basis of a single profit splitting factor or a weighting of multiple factors.

2.171. Profit splitting factors based on assets or capital (e.g. operating assets, fixed assets (e.g. production assets, retail assets, IT assets), intangibles), or costs (e.g. relative spending and/or investment in key areas such as research and development, engineering, marketing) may be used where these capture the relative contributions of the parties to the profits being split and they can be measured reliably. Note that while costs may be a poor measure of the value of intangibles contributed (see paragraph 6.142), the relative costs incurred by parties may provide a reasonable proxy for the relative value of those contributions where such contributions are similar in nature (see paragraphs 8.27-8.28).

2.172. Other profit splitting factors that could be appropriate in the circumstances of a given case include incremental sales, or employee compensation (relating to the individuals involved in the key functions that generate value to the transaction, for example in relation to the global trading of financial instruments). In other situations it is possible that headcount or time spent by a certain group of similarly skilled employees with similar responsibilities could be used if there is a strong and relatively consistent correlation between this and the creation of value represented by the relevant profits. The guidance in this section should not be considered as an exhaustive list of potential profit splitting factors. Other profit splitting factors may be acceptable provided they result in arm's length outcomes for all relevant parties.

2.173. In addition to the Local File, which should contain a detailed functional analysis of the taxpayer and its relevant associated enterprises, the MNE group's Master File might be a useful source of information relevant to the determination of appropriate profit splitting factors. As is set out in Annex I to Chapter V, the Master File should include information on the important drivers of business profit, the principal contributions to value creation by entities within the group, and key group intangibles. However, it should be borne in mind that the Master File is intended only to provide a high-level overview of an MNE group, and not granular or detailed information as to all of the group's transactions.

C.5.2. Reliance on data from the taxpayer's own operations (internal data)

2.174. Where comparable uncontrolled transactions of sufficient reliability are lacking to support the division of the relevant 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 in paragraphs 2.147-2.148 and 2.166. They will frequently be extracted from the taxpayers' cost accounting or financial accounting.

2.175. For instance, where an asset-based profit splitting factor 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 up a "transactional" balance sheet that will be used for the application of the transactional profit split method. In addition, certain assets, such as self-developed intangibles, may not be reflected on the balance sheet at all, and accordingly must be separately evaluated. In this regard, valuation techniques, such as those based on the discounted value of projected future income streams or cash flows derived from the exploitation of the intangible may be useful. See Section D.2.6.3 of Chapter VI of these guidelines. 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 profit splitting factor is used.

2.176. Similarly, where cost-based profit splitting factors are used that are based on data extracted from the taxpayers' profit and loss accounts, it may be necessary to draw up 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 profit splitting factor. 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.

2.177. Internal data may also be helpful where the profit splitting factor is based on a cost accounting system, e.g. employee costs related to some aspects of the transaction, or time spent by a certain group of employees on certain tasks, etc.

2.178. 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 unique and valuable intangibles and the assumption of economically significant risks and the importance, relevance and measurement of the factors which gave rise to these.

C.5.3. Examples of profit splitting factors

C.5.3.1. Asset-based profit splitting factors

2.179. Asset-based or capital-based profit splitting factors can be used where there is a strong correlation between tangible assets or intangibles, or capital employed and creation of value in the context of the controlled transaction. In order for a profit splitting factor 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. Example 15 in Annex II to this chapter illustrates the principles of this section.

2.180. Where one or more of the parties to a transaction for which the transactional profit split method is found to be the most appropriate makes a contribution in the form of intangibles, difficult issues can arise in relation both to their identification and to their valuation. Guidance on the identification and valuation of intangibles is found at Chapter VI of these Guidelines. See also the examples in Annex I to Chapter VI "Examples to illustrate the guidance on intangibles."

C.5.3.2. Cost-based profit splitting factors

2.181. A profit splitting factor based on expenses may be appropriate where it is possible to identify a strong correlation between relative expenses incurred and relative value contributed. For example, marketing expenses may be an appropriate factor for distributors-marketers if advertising generates unique and valuable 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 unique and valuable intangibles such as patents. However, if, for instance, each party contributes different valuable intangibles, then it is not appropriate to use a costbased factor unless cost is a reliable measure of the relative value of those intangibles or costs can be risk-weighted to achieve a reliable measure of relative value. Even where each party contributes the same kind of intangibles, risk-weighting will be an appropriate consideration. For example, where the risk of failure at an early stage of development is several times higher than the risk of failure at a later stage or in the development of incremental improvements to an already proven concept, then the costs incurred in that early stage will have a higher risk weighting than the costs incurred at a later stage or on incremental improvements. Employee remuneration may be relevant in situations where functions relating to the skills and experience of staff are the primary factor in generating the relevant profits.

2.182. In identifying and applying appropriate cost-based profit splitting factors a number of issues may need to be considered. One is that there may be differences between the parties in the timing of expenditure. For example, research and development costs that are relevant to the value of a party's contributions may have been incurred several years in the past, whereas the expenditure for another party may be current. As a result, it may be necessary to bring historic costs to current values (as discussed further below) in addition to the risk weighting described in paragraph 2.181. The relevant costs may be part of a larger cost pool that needs to be analysed and allocated to the contributions made to the profit split transaction. For example, marketing costs may be incurred and recorded across several product lines, whereas only one product line is the subject of the profit split transaction. Where location savings retained by member(s) of the MNE group are a significant contributor to profits, and such costs are included in the profits to be split, then the manner in which independent parties would allocate retained location savings would need to be reflected in the profit split, taking into account the guidance in Section D.6 of Chapter I. Cost-based profit splitting factors can be very sensitive to differences and changes in 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 profit splitting factor and to determine the factor consistently among the parties.

2.183. In some cases, a significant issue for the reliability of cost-based splitting factors is the determination of the relevant period of time from which the elements of determination of the profit splitting factor(s) (e.g. assets, costs, or others) should be taken into account. A difficulty arises because there can be a 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 factor, 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 amortisation, 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 in Section C.5.1 above, the selection of the profit splitting factor 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. The principles of this section are illustrated by Example 16 in Annex II to Chapter II of this guidance.

D. Conclusions on transactional profit methods

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

2.185. 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 jurisdictions 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).

2.186. 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.

2.187. 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 jurisdictions will have a certain degree of sophistication in their underlying tax systems before applying these methods.