This is a working draft of a Chapter of the Practical Manual on Transfer Pricing for Developing Countries and should not at this stage be regarded as necessarily reflecting finalised views of the UN Committee of Experts on International Cooperation in Tax Matters or its Subcom While several members of the Subcomm

and appropriate attribution will be made in a later version, the Secretariat particularly notes the contribution of Monique van Herksen.

Chapter 4 - Transfer Pricing Methods (Traditional Methods)

1. Introduction

This Chapter describes several transfer pricing methods that can be used to determine an arm's length price and it describes how to apply these methods in practice. In general, an OECD-consistent analysis is followed, with emphasis on practicality solutions when using and applying transfer pricing methods.

1.1 Use of methods

In order calculate or test the use of an arm's length result, use is made of transfer pricing methods. Transfer pricing methods are ways of calculating the profit margin of (a) transaction(s) or of calculating a transfer price that qualifies as being at arm's length. The application of transfer pricing methods is required to assure that transactions between Associated Enterprises do not violate the arm's length standard. Please note that although the term "profit margin" is used, companies may also have legitimate reasons to report losses and at arm's length on occasion may report losses. Furthermore, transfer pricing methods are not determinative in and of themselves. If an associated enterprise reports an arm's length amount of income, without the explicit use of one of the mentioned OECD recognized transfer pricing methods, there may be no reason to impose adjustments. It will be more challenging to substantiate that the amount of income reported qualifies as being at arm's length in such situations, however.

1.2 Selection of methods (how, why and use of more than one method)

Some methods are more appropriate and indicative to provide for an arm's length result for certain functions than others. For example, a cost-based method is usually deemed more useful for determining an arm's length price for services and manufacturing, and a

For all transfer pricing methods access to information on comparables is necessary and it may be that due to difficulty in getting access to (publicly available) data, in certain instances, other methods may need to be resorted to than those that would seem initially preferred and most reliable.

1.3 Choice of available methods

The so-called traditional transaction methods (CUP, Cost Plus and Resale Price Method) are preferred in certain countries, although no hierarchy of methods is being advocated in this Transfer Pricing Manual, other than applying a method that reliably calculates or tests the company's transfer pricing and application of the arm's length standard.

Considering the difficulty and cost of getting access to reliable data, taxpayers may want to make use of industry margins when applying the chosen and appropriate transfer pricing method. Once a method is chosen and applied, taxpayers are required to use and apply a method in a consistent fashion. Assuming an appropriate transfer pricing method is being applied, only if facts or functionalities change and those changes require a change in methods, is a change in methods envisaged.*

2. Current methods

2.1.1 Comparable Uncontrolled Price

The Comparable Uncontrolled Price ("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. The CUP method evaluates whether the amount charged in a controlled transaction is arm's length one by reference to the amount charged in a comparable uncontrolled transaction.

The CUP method applies to controlled transactions of tangible property and services. CUPs may be found as internal transactions and as external transactions. Figure 1 below explains this distinction.

* Working Draft Editorial note: One possibility would be that taxpayers need not benchmark their transfer pricing with a formal benchmark search in cases where functions and transactions subject to the benchmark do not exceed a stated

The controlled transaction in this figure

Difficulties resulting from performing reasonably accurate adjustments to remove the effect of material differences on prices should not automatically prevent the use of the CUP method. The CUP method should instead be complemented by other methods and one should try very hard to perform reliable adjustments.

If reliable adjustments cannot be performed, the reliability of the CUP method is decreased. Another transfer pricing method may then be used in combination with the CUP method or considered instead of the CUP method.

2.1.3 Strengths and Weaknesses

determine the degree of comparability between the controlled and uncontrolled transactions based on the comparability factors. If no internal CUPs can be found, then

2.2.2 Mechanism of Resale Price Method

The mechanism of the resale price method reduces the price of a product that the related sales company (i.e. Associated Enterprise 2 in Figure 2) charges to an unrelated customer (i.e. the resale price) with an arm's length gross margin, which the sales company uses to cover its selling, general and administrative (SG&A) expenses, and still make an appropriate profit, taking into account the functions performed and risks incurred. The remainder is regarded as an arm's length transfer price for the intercompany transactions between the sales company (i.e. Associated Enterprise 2) and a related company[2] (i.e. Associated Enterprise 1).

Under the resale price method, the starting point of the internal price setting procedure is the sales company.

The formula for the transfer price in intercompany transactions of products is as follows:

TP = RSP x (1-GPM),

where:

- TP = the Transfer Price of a product sold between a sales company and a related company;
- RSP = the Resale Price at which a product is sold by a sales company to unrelated customers; and
- GPM = the Gross Profit Margin that a specific sales company should earn, defined as the ratio of gross profit to net sales. Gross profit is defined as Net Sales minus Cost of Goods Sold.

As an example, let us assume that the resale price in Figure 2 is € 10,000. This means that Associated Enterprise 2 resells the car to the Independent Enterprise for € 10,000. Assume that an arm's length gross profit margin that Associated Enterprise 2 should earn is 25 %. Associated Enterprise 2 should cover its SG&A expenses and make an appropriate profit with this 25% gross margin. The resulting transfer price between Associated Enterprise 1 and Associated Enterprise 2 (i.e. the cost of goods sold of Associated Enterprise 2) is € 7,500 (i.e. € 10,000 x (1-0.25).

If the sales company acts as a sales agent that does not take title to the goods, it is possible to use the commission earned by the sales agent represented as a percentage of the uncontrolled sales price of the goods concerned as the comparable gross profit margin. The resale price margin for a reseller performing a general brokerage business should be established considering whether it is acting as an agent or a principal.

2.2.3 Arm's Length Gross Profit Margin

The financial ratio analysed under the resale price method is the gross profit margin, which is defined as the gross profit to net sales ratio of the sales company.

[2] Usually a manufacturing company owning valuable patents or the principal in a commissionaire arrangement.

As discussed above, gross profit equals net sales -/- cost of goods sold of a sales company. The net sales of a sales company concern the sales revenue obtained by

2.2.5 Comparability

In applying the resale price method, an uncontrolled transaction is considered comparable to a controlled transaction if:

- there are no differences between the transactions being compared that materially affect the gross margin; or
- reasonably accurate adjustments can be performed to eliminate the effect of such differences.

Under the resale price method, functional comparability is important, while product comparability is less important. Product differences are less critical for the resale price method than for the CUP method, because it is less probable that small product differences have a material effect on profit margins than on price. One would expect a similar level of compensation for performing similar functions across different activities.

The OECD Guidelines present an example where the compensation for a distribution company should be the same whether it sells toasters or blenders, because the functions performed (including risks incurred and assets used) are similar for the two activities. The price of a toaster will, however, differ from the price of a blender, as the two products are not close substitutes. Although product comparability is less important under the resale price method, it still applies that closer product similarity will lead to better results of the transfer pricing analysis. In this respect, product comparability will become more important when the transaction involves a unique intangible property. This means that it is not necessary to conduct a resale price analysis for each individual product line distributed by the sales company. Instead, the resale price method is generally not applied on specific product lines, but rather used to define the gross margin a sales company should earn over its full range of products.

equipment), business experience (e.g., start-up phase or mature business), or management efficiency.

- A resale price margin requires particular attention in case the reseller adds substantially to the value of the product (e.g., by assisting considerably in the creation or maintenance of intangible property related to the product (e.g., trademarks or tradenames) and goods are further processed into a more complicated product by the reseller before resale).

- The amount of the resale price margin will be affected by the level of activities performed by the reseller. For example, the distribution services provided by a reseller acting as a sales agent will be less extensive than those provided by a reseller acting as a buy-sell distributor. The buy-sell distributor will obviously obtain a higher compensation than the sales agent.

- If the reseller performs a significant commercial activity besides the resale activity

Figure 3 explains this further. Associated Enterprise 1, a car manufacturer in country 1, manufactures under contract for Associated Enterprise 2. Associated Enterprise 2 will instruct Associated Enterprise 1 about the quantity and quality of the cars to be manufactured. Associated Enterprise 1 will have guaranteed sales to Associated Enterprise 2 and will face little risk. If the CUP method cannot be applied, then the resale price method and the cost plus method are the next methods to be considered. Because Associated Enterprise 1 is less complex in terms of functions and risks in comparison with Associated Enterprise 2, the analysis would focus on Associated Enterprise 1 as the tested party. Since Associated Enterprise 1 can be regarded as (a simple) manufacturer, the cost plus method is the best method of analysis in subject case. The cost plus method analyses whether the gross profit mark-up earned by Associated Enterprise 1 is arm's length or not. The cost plus method thus does not directly test whether the tra/TT4 1 Tfo.2(the2)-5. Tf-5. TfA2earne bebj0 oe(p)2(s)-.1( )le he5s les5. Tfn Tw

As an example, let us assume that the COGS in Figure 3 is € 5,000. Assume that an arm's length gross profit mark-up that Associated Enterprise 1 should earn is 50 %. The resulting transfer price between Associated Enterprise 1 and Associated Enterprise 2 is €7,500 (i.e. € 5,000 x (1 + 0.50)).

2.3.3 Arm's Length Gross Profit Mark-up

The financial ratio considered under the cost plus method is the gross profit mark-up, which is defined as the gross profit to cost of goods sold ratio of a manufacturing company.

As discussed above, gross profit equals net sales -/- cost of goods sold of a sales company. For a manufacturing company, cost of goods sold show the cost of producing the goods sold. It includes direct labour, direct material and factory overheads associated with production.

Gross profit mark-ups will not be comparable if accounting principles differ between the controlled transaction and the uncontrolled transaction. Gross profit mark-ups should therefore be calculated uniformly between the tested party and the comparable companies. For example, the comparable manufacturers may differ from the related party manufacturer in reporting certain costs (e.g., costs of R&D) as operating expenses or as cost of goods sold. Differences in inventory valuation methods will also affect the computation of the gross profit mark-up. Appropriate adjustments should therefore be performed to ensure that gross profit mark-up is calculated in a consistent way.

The costs and expenses of a company normally consist of the following three groups: direct cost of producing a product or service (e.g., cost of raw materials), indirect costs of production (e.g., costs of a repair department that services equipment used to manufacture different products), and operating expenses (e.g., SG&A expenses). The cost plus method considers a profit margin that is calculated after direct and indirect costs of production have been subtracted. A net margin analysis also considers operating expenses. Due to differences between countries, the boundaries of the three groups of costs and expenses are not clear-cut in each and every case In a situation in which it is necessary to consider certain operating expenses to obtain consistency and comparability, the cost plus method of analysis comes close to a net margin analysis instead of a gross margin analysis.

For example, assume that Associated Enterprise 1, the car manufacturer which manufactures the cars under contract for Associated Enterprise 2, earns a gross profit mark-up of 15 percent on its cost of goods sold and classifies SG&A expenses as operating expenses that are not part of cost of goods sold. Four comparable independent manufacturers are identified which earn gross profit mark-ups between 10 to 15 percent.

transactions. The operating expenses in connection with the functions performed and risks incurred should be taken into account in

basis of the consignment case will include the value added cost of the contract manufacturer. Hence, the mark-up is applied only to these value added cost. In the turnkey case, the cost basis include the total cost of goods sold (including raw materials) of the contract manufacturer.

The total costs (TC) of the turnkey manufacturer equal the sum of raw material cost (RMC) and value added cost (VAC): TC = RMC + VAC.

The arm's length mark-up will be equal to:

(RMC/TC) * mark-up on RMC + (VAC/TC)* mark-up on VAC

The mark-up on VAC will generally be higher than the mark-up on RMC.

The arm's length mark-up for the consignment manufacturer is equal to the

- historical costs should in principle be ascribed to individual units of production. If costs differ over a period, average costs over the period may be used.

- One discussion regards whether budgeted cost or actual cost should be used in applying the cost plus method. On the one hand using actual costs will better reflect the few risks faced by the contract manufacturer.[3] On the other hand, third parties will usually used budgeted costs in selling products to the market. That is, you will not charge the customer an additional amount at the end of the year if actual costs are higher than budgeted costs. Disbursements on which no mark-up is applied will often be based on actual costs.

- as the costs that may be regarded in using the cost plus method are only those of the manufacturer of the goods or the service provider, a problem may arise with respect to the allocation of some costs between the manufacturer / service provider and the purchaser of goods/services.

- in case the transactions involve the removal of marginal production, it may be possible to use variable costs or marginal costs.

2.3.7 Strengths and Weaknesses

The strengths of the cost plus method include:

- third parties are found that indeed use cost plus method to set prices; and
- it is based on internal costs, the information of which is available to the multinational enterprise.

The weaknesses of the cost plus method include:

- there may be no link between the level of costs and the market price;
- accounting consistency is required between the controlled and uncontrolled transactions;
- it is a one-sided analysis as the analysis focuses on the related party manufacturer. Hence, the arm's length gross profit mark-up found may lead to an extreme result for the other related parties involved in the controlled transaction (e.g., operating losses);
- if method is based on actual costs, there may be no incentive for the manufacturer to control costs

2.3.8 When to Use to Cost Plus Method?

The cost plus method is typically applied in cases involving the intercompany sale of tangible property where the related party manufacturer performs limited manufacturing functions and incurs low risks, because the level of the costs will then better reflects the value being added and hence the market price. The cost plus method is thus generally used in transactions involving a contract manufacturer, a toll manufacturer or a low risk assembler which does not own product intangibles and incurs little risks. The related customer involved in the controlled transaction will generally be much more complex

[3] Note that if the contract is based on actual costs, the contractual terms may include incentives or penalties depending on the performance of the contract manufacturer.