B.3. Methods

B.3.1. Introduction to Transfer Pricing Methods

B.3.1.1. This part of the chapter describes several transfer pricing methods that can be used to determine an arm's length price and describes how to apply these methods in practice. Transfer pricing methods (or "methodologies") are used to calculate or test the arm's length nature of prices or profits. Transfer pricing methods are ways of establishing arm's length prices or profits from transactions between associated enterprises. The transaction between related enterprises for which an arm's length price is to be established is referred to as the "controlled transaction". The application of transfer pricing methods helps assure that transactions conform to the arm's length standard. It is important to note that although the term "profit margin" is used, companies may also have legitimate reasons to report losses at arm's length. 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 recognized transfer pricing methods, this does not mean that its pricing should automatically be regarded as arm's length. In regard to the availability of reliable information (in particular on uncontrolled comparables) needed to apply the selected method; and the degree of comparability between the controlled and uncontrolled

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B.3.1.2.2. The functions performed: The functional analysis describes the activities performed such as design, purchasing, inbound logistics, manufacturing, research and development (R&D), assembling, inventory management, outbound logistics, marketing and sales activities, after sale services, supporting activities, services, advertising, financing and management, etc. The functional analysis must specify which party performs each activity and in case both parties are involved in performing an activity it should provide for the relevant differences; for example if both have inventories but Company A holds inventories for a period of up to two years whereas Company B holds inventories for a period of one month. The activities that add most value must be identified and should be discussed in more detail.

B.3.1.2.3. The risks undertaken: The functional analysis should identify risks undertaken. Examples are: financial risk (currency, interest rate, funding risks etc) credit and collection risk (trading credit risk, commercial credit risk), operational risk (systems failure risk), commodity price risk, inventory risk and carrying costs, R&D risk, environmental and other regulatory risks, market risk (country political risk, reliability of customers, fluctuation in demand and prices) and product risk (product liability risk, warranty risk and costs and contract enforceability). A risk-bearing party would expect to have higher earnings than a non-risk bearing party, and will incur the expenses and perhaps related loss if and when risk materializes.

B.3.1.2.4. The assets used or contributed: The functional analysis must identify and distinguish between tangible and intangible assets. Tangible assets such as property, plant and equipment have to be financed and an investment in such capital assets would usually be expected to earn a long term return based on the use and risk level of the investment. Intangible assets are very important as substantial competitive advantage is often achieved by the use of intangible assets. Some intangibles have legal protection (e.g. patents, trademarks, trade names) but other intangibles with less legal protection may be equally important and valuable (e.g. know-how, trade secrets, marketing intangibles, etc).[1]

B.3.1.2.5. Interplay of above factors: Today, in a multinational group, operations tend to be more integrated across jurisdictional boundaries and the functions, risks and assets are often shared between entities in different jurisdictions. This makes functional analyses both more difficult and more necessary. The functional analysis can help identify which functions, risks and assets are attributable to the various related parties. For example, the functional analysis may reveal that one company performs one particular function but the cost of this is borne by the other party to the transaction. The functional analysis could highlight that situation and consider the legal allocation of risk and the economic substance of the transaction. Another example would be where a company performs one particular function and bears the cost therr8 (on)1t (s)-1.1l corin t theccntics stacer the ransactioo 9e funp6unpionalc t t thert(i)-16 (o)-4-5

B.3.1.2.6. Selecting a method after the functional analysis: Once the functional analysis is performed the application of a transfer pricing method, with the associated evaluation of comparable transactions, may be considered. Transfer pricing methods typically use information on comparables; the lack of such comparables can make a particular method — even one that might seem initially preferred — inapplicable, and a different method more reliable. These comparable transactions are also referred to as "uncontrolled transactions" because the parties involved in the transactions are independent of each other. Although uncontrolled transactions of independent unrelated companies are usually used as comparables for transfer pricing purposes, in practice it is sometimes not possible to identify reliable comparable data in the same markets. In such cases practical solutions should be sought in good faith by taxpayers and the tax administration. Comparability issues are discussed in more detail at Chapter B.2.

B.3.1.2.7. Solutions for cases where comparables are difficult to find may include the following:

- Searching for comparables in other industries where such comparable companies have similar functions, assets and risks;
- Searching for comparables in other geographical regions that share certain key similarities with the country in which a company conducts its business; and
-

B.3.1.3.2. No preference for particular methods is being advocated in this Manual. The most suitable method should be chosen taking into consideration the facts and circumstances. The taxpayer should for example take into account the type of transaction, the functional analysis, comparability factors, availability of comparable transactions and the possibility of making adjustments to the data to improve comparability. For further discussion on this issue, see Chapter B.2.

B.3.1.3.3. Once a method is chosen and applied, taxpayers are generally expected to apply the method in a consistent fashion. Assuming that an appropriate transfer pricing method is being applied, a change in the method is typically required only if there are any changes in the facts, functionalities or availability of data.

B.3.2. Traditional Transaction Methods

B.3.2.1. Comparable Uncontrolled Price

B.3.2.1.1. 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 may also sometimes be used to determine the arm's length royalty for the use of an intangible asset. CUPs may be based on either "internal" comparable transactions or on

Associated Enterprise 2, a bicycle importer in Country 2, which purchases, imports and resells the bicycles to unrelated bicycle dealers in Country 2. Associated Enterprise 1 is the parent company of Associated Enterprise 2.

B.3.2.1.3. In applying the CUP Method to determine whether the price charged for bicycles transferred in this controlled transaction is at arm's length, the following information is assumed to be available for consideration:

- The price charged for bicycles transferred in a comparable uncontrolled transaction between Associated Enterprise 1 and Unrelated Party C (i.e. transaction #1);
- The price charged for bicycles transferred in a comparable uncontrolled transaction between Associated Enterprise 2 and Unrelated Party A (i.e. transaction #2); and
- The price paid for bicycles transferred in a comparable uncontrolled transaction between (s)-11 (e)-6 (2)-10 (a)-6 (nd)-10 (U)-8 (nr)-7 (e)4 (l)-12 (a)4 (t)-(a)4 (n)-10tanananan

B.3.2.2.4. Although product comparability is important in applying the CUP Method, the other comparability factors should not be disregarded. Contractual terms and economic conditions are

competitiveness of the bicycle market in the two countries and differences in government regulations if relevant.

B.3.2.2.6. Reasonably accurate adjustments may *not* be possible for:

- Unique and valuab

B.3.2.5 Case Examples of Use of the CUP Method

B.3.2.5.1. Example 1: Comparable Sales of Same Product

MCO, a manufacturer, sells the same product to both controlled and uncontrolled distributors. The circumstances surrounding the controlled and uncontrolled transactions are substantially the same, except that the controlled sales price is a delivered price and the uncontrolled sales are made free on board (f.o.b.) MCO's factory (which means the buyer takes responsibility for delivery costs of the goods for the remainder of their transit). Differences in the contractual terms of transportation and insurance generally have a definite and reasonably ascertainable effect on price, and adjustments are made to the results of the uncontrolled transaction to account for such differences. No other material difference has been identified between the controlled and uncontrolled transactions. As MCO is engaged in both controlled and uncontrolled transactions, it is likely that all material differences between the two transactions have been identified. In addition, the Comparable Uncontrolled Price Method is applied to an uncontrolled comparable with no product differences, and there are only minor contractual differences that have a definite and reasonably ascertainable effect on price. The results of this application of the Comparable Uncontrolled Price Method will therefore provide the most direct and reliable measure of an arm's length result.

B.3.2.5.2. Example 2: Effect of Trademark

The facts are the same as in Example 1 except that MCO affixes its valuable trademark to the property sold in the controlled transactions but does not affix its trademark to the property sold in the uncontrolled transactions. Under the facts of this case the effect on price of the trademark is material and cannot be reliably estimated. As there are material product differences for which reliable adjustments cannot be made the Comparable Uncontrolled Price Method is unlikely to provide a reliable measure of the arm's length result.

B.3.2.5.3 Example 3: Minor Product Differences

The facts are the same as in Example 1 except that MCO, which manufactures business machines, makes minor modifications to the physical properties of the machines to satisfy specific requirements of a customer in controlled sales. MCO does not however make these modifications in uncontrolled sales. Only if the minor physical differences in the product have a material effect on prices should adjustments be made to the results of the uncontrolled transactions to account for these differences. These adjusted results may then be used as a measure of the arm's length result.

B.3.2.5.4. Example 4: Effect of Geographic Differences

B.3.2.6. Resale Price Method

B.3.2.6.1. The Resale Price Method (RPM) is one of the traditional transaction methods that can be used to determine whether a transaction reflects the arm's length principle. The Resale Price Method focuses on the related sales company which performs marketing and selling functions as the tested party in the transfer pricing analysis. This is depicted in Figure 6.2 below.

B.3.2.6.2. The Resale Price Method analyses the price of a product that a related sales -10 Bes -1ed ies n

B.3.2.6.3. Consequently, under the RPM the starting point of the analysis for using the method is the sales company. Under this method the transfer price for the sale of products between the sales company (i.e. Associated Enterprise 2) and a related company (i.e. Associated Enterprise 1) can be described in the following formula:

TP = RSP x (1-GPM), where:

- TP = the *Transfer Price*

gross margins. It is thus important that the analysis does not compare “apples with oranges” but rather, “apples with apples”. Therefore, appropriate adjustments should be applied to the data used in computing the gross margin to make sure that “similar” gross margins are compared.

B.3.2.8. Transactional Comparison versus Functional Comparison

B.3.2.8.1. The arm’s length price or margin can result from looking at comparable functionality (distributors of broadly similar types of product) or from making a transactional comparison by looking at each transaction the tested party engages in involving comparable products (i.e. sales of different types of bicycles).

B.3.2.8.2. The arm’s length (range of) gross profit margin(s) to be earned by the sales company in the controlled transaction can therefore be determined in the following two ways:

- By transactional comparison: For example, one could determine the gross profit margin that Associated Enterprise 2 earns when reselling bicycles purchased from an independent manufacturer in a comparable uncontrolled transaction. This uncontrolled transaction may initially have been rejected as an internal comparable for purposes of applying the CUP Method because, for example, the transaction involves a different type of bicycle. If the sale of recreational bicycles is at issue, but the unrelated transactions involve bicycle rickshaws (pedicabs) or the like this may involve broadly similar products with comparable accounting measures of Costs of Goods Sold (COGS) making gross margin comparisons sufficiently reliable; and
- By functional comparison: the gross profit margins earned by independent companies in comparable uncontrolled transactions performing functions and incurring risks comparable to the functions performed and risks incurred by Associated Enterprise 2. Functional comparison thus involves a search for comparable distribution companies rather than comparable transactions. This could,

creation or maintenance of intangible property related to the product (e.g. trademarks or trade names) or where 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 in relation to the resale activity itself, or if it employs valuable and unique assets in its activities (e.g. valuable marketing intangibles of the reseller), it may earn a higher gross profit margin;
- The comparability analysis should try to take into account whether the reseller has the exclusive right to resell the goods, because exclusive rights may affect the resale price margin;
- The analysis should consider differences in accounting practices that apply to the reseller and to comparable companies in order to make appropriate adjustments to enhance comparability; and
- The reliability of the analysis will be affected by differences in the value of the products distributed, for example, as a result of a valuable trademark.

B.3.2.9.7. It should be recognized that returns to similar functions may not be the same in different markets. Generally, reliability is enhanced when the reseller and the comparable companies are operating in the same market.

B.3.2.10. Strengths and Weaknesses of the Resale Price Method

B.3.2.10.1. The strengths of the Resale Price Method include:

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- The method involves a one-sided analysis, as its focus is on the related sales company as the tested party in the transfer pricing analysis. It is possible that the arm’s length

B.3.2.12. Case Examples of the Resale Price Method

B.3.2.12.1. Example 1

A controlled taxpayer sells property to another member of its controlled group which resells the property in uncontrolled sales. It is for all practical purposes assumed that there are no changes in the beginning and ending inventory for the year under review. Information regarding an uncontrolled comparable is sufficiently complete to conclude that it is likely that all material differences between the controlled and uncontrolled transactions have been identified and adjusted for. If the applicable resale price of the property involved in the controlled sale is $100 and the appropriate gross profit margin is 20 per cent, then an arm's length result of the controlled sale is a price of $80 ($100 - (0.2%×$100)).

B.3.2.12.2. Example 2

SCO, a Country B corporation, is the distributor for FP, its foreign parent. There are no changes in the beginning and ending inventory for the year under review. SCO's total reported cost of goods sold is $800, consisting of $600 for property purchased from FP and $200 for other costs of goods sold incurred to unrelated parties. SCO's applicable resale price and reported gross profit are as follows:

Applicable resale price $1 000
Cost of goods sold: Cost of purchases from FP $600
Costs incurred to unrelated parties $200
Reported gross profit $200

The local taxing authority determines that the appropriate gross profit margin is 25 per cent. Therefore, SCO's appropriate gross profit is $250 (i.e. 25 per cent of the applicable resale price of $1000). As SCO is incur-ring costs of sales to unrelated parties, an arm's length price for property purchased from FP must be determined under a two-step process. First, the appropriate gross profit ($250) is subtracted from the applicable resale price ($1000). The resulting amount ($750) is then reduced by the costs of sales incurred to unrelated parties ($200). Therefore, an arm's length price for SCO's cost of sales of FP's product in this case equals $550 (i.e., $750 minus $200) and not $600.

B.3.2.12.3. Example 3

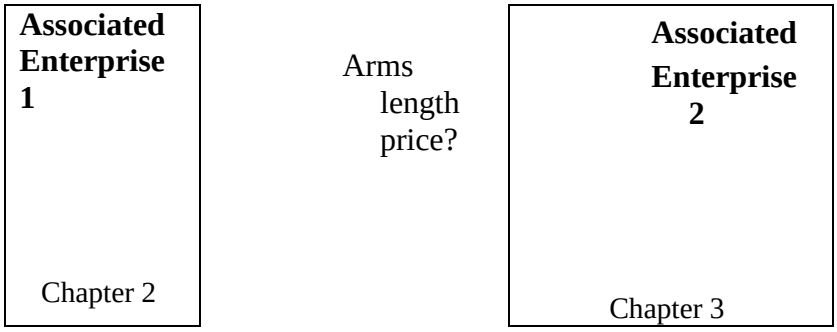
FM, a foreign manufacturer, sells Product to UCO, its subsidiary in Country U, which in turn sells Product to its domestic affiliate BCO. BCO sells Product to unrelated buyers. In this case, the applicable resale price is the price at which BCO sells Product in uncontrolled transactions. The determination of the appropriate gross profit margin for the sale from UCO to BCO will take into account the functions performed by UCO and BCO, as well as other relevant factors.

B.3.2.12.4. Example 4

Although close product similarity is not as important for a reliable application of the Resale Price Method as for the Comparable Uncontrolled Price Method, significant differences in the value of the products involved in the controlled and uncontrolled transactions may affect the reliability of the results. In addition, because in this case it is difficult to determine the effect the trademark will have on price or profits, reliable adjustments for the differences cannot be made. Because transactions involving Companies D and E have a higher level of comparability than those involving Companies A, B, and C with Company S, only transactions involving Companies D and E may be included in determining the arm's length gross margin.

B.3.2.13. Cost Plus Method

Figure B.3.3:



Costs for Associated Enterprise 1	=	$ 500
+ ***Gross Profit Mark Up (50%)***	=	$ 250
Arm's length price	=	$ 750

It is assumed that the COGS in Figure B.3.3. is $500. If it is assumed also that an arm's length gross profit mark-up that Associated Enterprise 1 should earn is 50 per cent, the resulting transfer price between Associated Enterprise 1 and Associated Enterprise 2 is $750 (i.e. $500 x (1 + 0.50)).

Like the Resale Price Method, the Cost Plus Method is a gross margin method; that is, it

B.3.2.14.2. The formula for the transfer price in inter-company transactions of products is as follows: TP = COGS x (1 + cost plus mark-up), where:

- TP = the *Transfer Price* of a product sold between a manufacturing company and a related company;
- COGS = the C*ost of Goods Sold* to the manufacturing company; and
- Cost plus mark-up = gross profit mark-up defined as the ratio of gross profit to cost of goods sold. Gross profit is defined as net sales minus cost of goods sold.

B.3.2.15. Arm's Length Gross Profit Mark-up for Cost Plus Method

B.3.2.15.1. [illegible]

B.3.2.15.4. Example: Accounting Consistency Issue

B.3.2.16. Transactional Comparison versus Functional Comparison

B.3.2.16.1. The arm's length price or margin can result from looking at comparable functionality (manufacturers of broadly similar types of product) or from making a transactional comparison by looking at each transaction the tested party engages in involving comparable products (e.g. manufacturing of different types of bicycle).

B.3.2.16.2. The arm's length (range of) gross profit mark-up(s) can be established in the following two ways:

- Transactional comparison: the gross profit mark-up earned by the related party manufacturer when selling goods to an independent enterprise in a comparable uncontrolled transaction, which previously has been rejected as an internal comparable for purposes of applying the CUP Method because for example, it involves different models of bicycle. If for example the controlled transaction involves the manufacturing of recreational bicycles, but the unrelated transactions involve bicycle rickshaws etc, these may involve broadly similar products, with comparable accounting measures of COGs making gross margin comparisons sufficiently reliable; and
- Functional comparison: the gross profit mark-ups earned by independent companies performing functions and incurring risks comparable to the functions performed and risks incurred by the related party manufacturer. Functional comparison involves a search for comparable manufacturing companies.

B.3.2.16.3. In practice, transactional comparisons are more likely to achieve the broad product and accounting consistency required for the Cost Plus Method than functional comparisons. In a transactional comparison, much more information about the controlled and uncontrolled transactions is available (e.g. contractual terms). In a functional comparison that is based on information provided in publicly available databases and in the annual reports of comparable companies and the tested party, much less specific information is available with

B.3.2.16.4. Based on benchmarking and financial analyses an arm's length range of gross profit mark-ups earned by comparable independent manufacturers will be determined. If the gross profit mark-up earned by the related party manufacturer falls within this range, then its

B.3.2.20.

B.3.2.21.2. Example 2

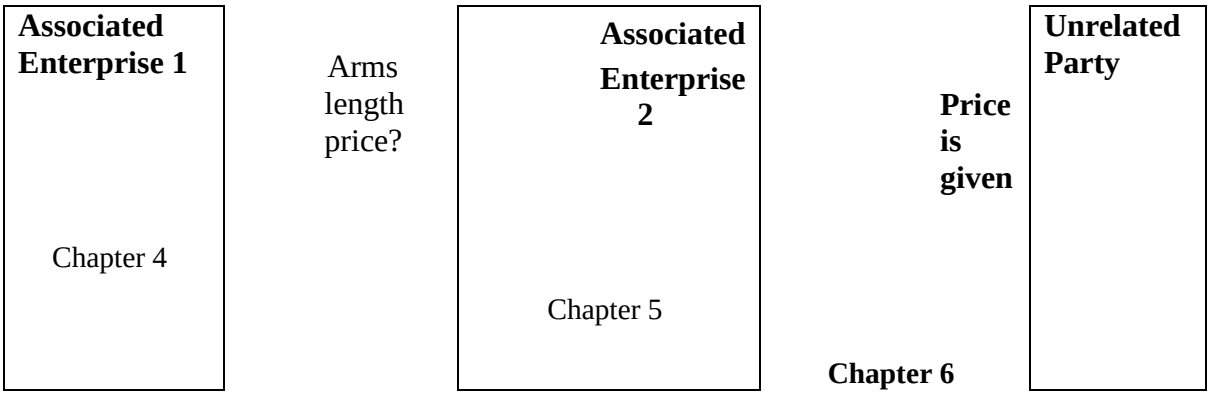
The facts are the same as in Example 1 except that LCO accounts for supervisory, general, and

example, it is not possible to determine which parties in the uncontrolled transactions bear currency risks. As the differences in these contractual terms could materially affect price or profits, the inability to determine whether differences exist between the controlled and uncontrolled transactions will diminish the reliability of these results. Therefore, the reliability of the results of the uncontrolled transactions must be enhanced.

B.3.3.

B.3.3.2.2.The TNMM compares the net profit margin[6] (relative to an appropriate base) that the tested party earns in the controlled transactions to the same net profit margins earned by the tested party in comparable uncontrolled transactions or alternatively by independent comparable companies. As it uses net margins to determine arm's length prices the TNMM is a less direct method than the Cost Plus Method and Resale Price Method that compares gross margins. It is

Figure B.3.4: Transactional Net Margin Method



Given price	=	$ **10,000**	
Cost of goods sold	=	$?	
Gross profit	=	$?	
Operating expenses	=	$ **2,000**	
Net profit (5 % of Price)	=	$ 500	*Comparable*

Associated Enterprise 1, a bicycle manufacturer in Country 1, sells bicycles to Associated Enterprise 2 which resells the bicycles to the independent enterprise, an unrelated bicycle dealer in Country 2. Assume that Associated Enterprise 1 is the more complex party, controlling a variety of technology and operating intangibles. The CUP Method would compare the price

product differences and cost accounting differences compared to traditional transaction methods) can be a significant practical benefit of using TNMM.

B.3.3.3.4. The application of the TNMM would entail an analysis of the least complex party — in this case the distributor. Such an analysis would entail a search for comparable distributors taking into account the comparability standard of this method. An application of the TNMM focusing on the related party manufacturer as the tested party could be, for example, the situation in which Associated Enterprise 1 is a contract manufacturer. In such a case, the contract manufacturer will typically be the least complex entity as MNEs often separate the ownership of valuable technology intangibles from the manufacturing function. The Cost Plus Method would normally be considered if the CUP Method cannot be applied. However, due to the accounting inconsistency mentioned above, it may be appropriate to apply the TNMM using a financial ratio based on net profit margin that is appropriate for a manufacturer (e.g. return on total costs).

the TNMM? The mechanism of the TNMM is similar to the mechanisms o
Method and Cost Plus Method as can be seen in the following examples at9.36
length transfer price the market price of products resold by the related party distri
unrelated customers (i.e. sales price) is known, while the arm's length gross profit m
determined based on a benchmarking analysis The transfer price or cost of goods so
related party distributor is the unknown variable. Assuming a resale price of $1g. n
gross profit margi

manufacturer using a profit level indicator such as the ratio of net profit to total cost. The sales price and the gross profit are the unknown variables. Assuming cost of goods sold of $5,000, operating expenses of $1,000 and an arm's length net profit to total cost ratio of 25 per cent, the transfer price amounts to $7,500. Table 6.4 illustrates that working backwards using the available information leads to the determination that the sales price (i.e. transfer price in this case) is $7,500.

Table B.3. 3: Mechanism of the Cost Plus Method

	Initially	Benchmarking analysis	Chapter 15
Resale price	?	$7 500	Chapter 16
Cost of goods sold	$5 000	5 000	Chapter 17

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Table B.3. 4

B.3.3.5. Examples[9]

B.3.3.5.1. Example 1: Transfer of Tangible Property Resulting in No Adjustment

FP is a publicly traded Country A corporation with a Country B subsidiary named BCO that is under audit for its 2009 taxable year. FP manufactures a consumer product for worldwide distribution. BCO imports the assembled product and distributes it within Country B at the wholesale level under the FP name.

FP does not allow uncontrolled taxpayers to distribute the product. Similar products are produced by other companies but none of them is sold to uncontrolled taxpayers or to uncontrolled distributors.

Based on all the facts and circumstances, Country B's taxing authority determines that the TNMM will provide the most reliable measure of an arm's length result. BCO is selected as the tested party because it engages in activities that are less complex than those undertaken by FP.

Chapter 23	2007	2008	2009	Average
Sales	$500,000	$560,000	$500,000	$520,000
COGS	$393,000	$412,400	$400,000	$401,800
Operating Expenses	$80,000	$110,000	$104,600	$98,200
Operating Profit	$27,000	$37,600	$(4,600)	$20,000

There is data from a number of independent operators of wholesale distribution businesses. These potential comparables are further narrowed to select companies in the same industry segment that perform similar functions and bear similar risks to BCO. An analysis of the information available on these taxpayers shows that the ratio of operating profit to sales is the most appropriate profit level indicator, and this ratio is relatively stable where at least three years are included in the average. For the taxable years 2007 to 2009, BCO shows the following results:

After adjustments have been made to account for identified material differences between BCO and the uncontrolled dili rett1 4 (t)-16 (f)-1 (o)-4 (rc 0.(hei2(fTc 0 Twp 0 Twp -28.74 -1.15 h1eas)-5 (t)-6 (t

The data is not sufficiently complete to conclude that it is likely that all material differences between BCO and the uncontrolled distributors have been identified. The Country B taxing

B.3.3.5.2. Example 2: Transfer of Tangible Property Resulting in an Adjustment

[break to be removed]

The facts are the same as in Example 1 except that BCO reported the following income and expenses:

Chapter 24	2007	2008	2009	Average
Sales	$500,000	$560,000	$500,000	$520,000
COGS	$370,000	$460,000	$400,000	$410,000
Operating Expenses	$110,000	$110,000	$110,000	$110,000
Operating Profit	$20,000	$(10,000)	$(10,000)	

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B.3.3.5.4.

years (derived from a group of similar uncontrolled comparables located in Country M and N) to HCO's average operating assets for the same period provides a set of comparable operating profits. The interquartile range for these average comparable operating profits is $3,000 to $4,500. HCO's average reported operating profit for the years 2007 to 2009 ($21,500) falls outside this range. Therefore, the taxing authority determines that an allocation may be appropriate for the 2009 taxable year.

To determine the amount, if any, of the allocation for the 2009 taxable year the tax authority compares HCO's reported operating profit for 2009 to the median of the comparable operating profits derived from the uncontrolled distributors' results for 2009. The median result for the uncontrolled comparables for 2009 is $3,750. Based on this comparison the district director increases royalties that HCO paid by $21,500 (the difference between $25,250 and the median of the comparable operating profits, $3,750).

B.3.3.5.5. Example 5: Adjusting Operating Assets and Operating Profit for Differences in Accounts Receivable

MCO manufactures parts for industrial equipment and sells them to its foreign parent corporation. For purposes of applying the TNMM, 15 uncontrolled manufacturers that are similar to MCO have been identified.MCO has a significantly lower level of accounts receivable than the uncontrolled manufacturers. Since the rate of return on capital employed is used as the profit level indicator, both operating assets and operating profits must be adjusted to account for this difference. Each uncontrolled comparable's operating assets is reduced by the amount (relative to sales) by which they exceed MCO's accounts receivable. Each uncontrolled comparable's operating profit is adjusted by deducting imputed interest income on the excess accounts receivable. This imputed interest income is calculated by multiplying each uncontrolled comparable's excess accounts receivable by an interest rate appropriate for short-

operating profit by a balance sheet figure. These PLIs are based on assets actively employed in the business. Such tangible assets consist of all assets minus investments (e.g. in subsidiaries), minus cash and cash equivalents beyond the amount needed for working capital. In the case of the ROA a deduction is also made for intangible assets such as goodwill. These two PLIs may, for example, be used for leasing companies. This type of PLI may be the most reliable if the tangible operating assets have a high correlation to profitability. For example a manufacturer's operating assets such as property, plant, and equipment could have more impact on profitability than a distributor's operating assets, since often the primary value added by a distributor is based on services it provides and these are often less dependent on operating assets. The difference between the ROA and the ROCE is that the ROA focuses on the assets used while

- Transactional comparison: the net profit margin that the tested party enjoys in a compa

B.3.3.9. Comparability

B.3.3.9.1. Product comparability is most important in applying the CUP Method, as differences in products will result in different prices. The Cost Plus Method and the Resale Price Method are less dependent on product comparability and focus on functional comparability because

	Controlled Transactions	Uncontrolled Transactions	Aggregate Transactions
Sales	$ 100,000	$ 100,000	$ 200,000
COGS	$ 90,000	$ 78,000	$ 168,000
Gross profits	$ 10,000	$ 22.000	$ 32,000
Operating expenses	$ 13,000	$ 15,000	$ 28,000
Operating profit	$ (3,000)	$ 7,000	$ 4,000
Operating profit margin	-/- 3%	7%	2%

B.3.3.11.

related party distributor is not at arm’s length. However, this conclusion may be incorrect if, due to accounting inconsistency, the related party differs from the comparable distributor in allocating costs between cost of goods sold and operating expenses.

B.3.3.13. Profit Split Method

B.3.3.13.1. The Profit Split Method is typically applied when both sides of the controlled transaction contribute significant intangible property. The profit is to be divided such as is expected in a joint venture relationship.

B.3.3.13.2. The Profit Split Method seeks to eliminate the effect on profits of special conditions made or imposed in a controlled transaction (or in controlled transactions that it is appropriate to aggregate) by determining the division of profits that independent enterprises would have expected to realize from engaging in the transaction or transactions. Figure 6.5 illustrates this.

~~**[Figure B.3.5: Profit Split Method]**~~

B.3.3.13.3. The Profit Split Method starts by identifying the profits to be divided between the associated enterprises from the controlled transactions. Subsequently, these profits are divided between the associated enterprises based on the relative value of each enterprise's contribution, which should reflect the functions performed, risks incurred and assets used by each enterprise in the controlled transactions. External market data (e.g. profit split percentages among independent enterprises performing comparable functions) should be used to value each enterprise's contribution, if possible, so that the division of combined profits between the associated enterprises is in accordance with that between independent enterprises performing functions comparable to the functions performed by the associated enterprises. The Profit Split Method is applicable to transfer pricing issues involving tangible property, intangible property, trading activities or financial services.

- External market benchmarks reflecting the fair market value of the intangible property;
- The capitalized cost of developing the intangibles and all related improvements and updates, less an appropriate amount of amortization based on the useful life of each

- The method avoids an extreme result for one of the associated enterprises involved due to its two-sided approach (i.e. all parties to the controlled transaction are being analysed); and
- This method is able (uniquely among commonly used transfer pricing methods) to deal with returns to synergies between intangible assets or profits arising from economies of scale.

B.3.3.16.2. The weaknesses of the Profit Split Method include:

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B.3.3.17.3. In step 1 of the residual analysis, a basic return for the manufacturing function is determined for Company A and Company B. Specifically a benchmarking analysis is performed to search for comparable independent manufacturers which do not own valuable intangible property. The residual profit, which is the combined profits of Company A and Company B after deducting the basic (arm's length) return for the manufacturing function, is then divided between Company A and Company B. This allocation is based on relative R&D expenses which are assumed to be a reliable key to measure the relative value of each company's intangible property. Subsequently, the net profits of Company A and Company B are calculated in order to work back to a transfer price.

B.3.3.17.4. The Profit Split Method involves the determination of the factors that bring about the combined profit, setting a relative weight to each factor and calculating the allocation of profits between the associated enterprises. The contribution analysis is difficult to apply, because external market data that reflect how independent enterprises would allocate the profits in similar circumstances is usually not available. The first step of the residual analysis often involves the use of the TNMM to calculate a return and is not, in itself, more complicated than the typical application of TNMM. The second step is, however, an additional step and often raises difficult additional issues relating to the valuation of intangibles.

B.3.3.18. Examples: Application of Residual Profit Split

(i) XYZ is a corporation that develops, manufactures and markets a line of products for use by the police in Country A. XYZ's research unit developed a bulletproof material for use in protective clothing and headgear (Stelon). XYZ obtains patent protection for the chemical formula for Stelon. Since its introduction, Stelon has captured a substantial share of the market for bulletproof material.

(ii) XYZ licensed its Asian subsidiary, XYZ-Asia, to manufacture and market Stelon in Asia. XYZ-Asia is a well-established company that manufactures and markets XYZ products in Asia. XYZ-Asia has a research unit that adapts XYZ products for the defence market, as well as a well-developed TJ 0 Tc 0 Tw 18.52 0 Td (-)TjTJ 06 ((-))]TJ - (eh>ii)-2 (n A3 (po)-10 (rk1 (e)4 (b)-20 (y

other than those attributable to highly valuable intangible property, it is assumed that the residual profit of $180 Million is attributable to the valuable intangibles related to Stelon, i.e. the Asian brand name for Stelon and the Stelon formula (including XYZ-Asia's modifications). To estimate the relative values of these intangibles the taxing authority compares the ratios of the capitalized value of expenditures as of 2009 on Stelon-related research and development and marketing over the 2009 sales related to such expenditures.

(vi) As XYZ's protective product research and development expenses support the worldwide protective product sales of the XYZ group, it is necessary to allocate such expenses among the worldwide business activities to which they relate. The taxing authority determines that it is reasonable to allocate the value of these expenses based on worldwide protective product sales. Using information on the average useful life of its investments in protective product research and development, the taxing authority capitalizes and amortizes XYZ's protective product research and development expenses. This analysis indicates that the capitalized research and development expenditures have a value of $0.20 per dollar of global protective product sales in the 2009 tax year.

(vii) XYZ-Asia's expenditures on Stelon research and development and marketing support only its sales in Asia. Using information on the average useful life of XYZ-Asia's investments in marketing and research and development the taxing authority capitalizes and amortizes XYZ-Asia's expenditures and determines that they have a value in 2009 of $0.40 per dollar of XYZ-Asia's Stelon sales.

(viii) Thus, XYZ and XYZ-Asia together contributed $0.60 in capitalized intangible development expenses for each dollar of XYZ-Asia's protective product sales for 2009, of which XYZ contributed a third (or $0.20 per dollar of sales). Accordingly, the taxing authority determines that an arm's length royalty for the Stelon license for the 2009 taxable year is $60 Million, i.e. one-third of XYZ-Asia's $180 Million in residual Stelon profit.

B.3.4 E M E D C MM D J E

B.3.4.1.

B.3.4.1.1 Transfer pricing rules require associated enterprises to price their intercompany transactions in accordance with the arm's length principle. The five methods set forth in Chapters B.3.2 and B.3.3 (Transfer Pricing Methods) of this Practical Manual are used to calculate or test the arm's length nature of intercompany prices or profits earned from intercompany transactions. As set forth in Chapter B.3.1.2.1, the starting point in selecting a transfer pricing method is an understanding of the controlled transaction (inbound or outbound) based on the comparability (including the functional) analysis. This is necessary regardless of which transfer pricing method is selected. The CUP method is a suitable method when prices from comparable transactions of the same or similar products are available. For

shipment is to a destination determined by an unrelated party that has bought the commodities from the associated trader (not to the residence of the associated trading entity).

B.3.4.2.1.3. If based on clear criteria that can be readily ascertained it is established that the associated trading entity has insufficient substance to perform relevant functions related to the acquisition and sale of commodities and the trading entity is located in a low tax jurisdiction, there is risk that the associated trading entity transaction serves to erode the tax base of the associated seller of the commodities. This can be done b

	other goods provided that those meet certain requirements: • the international intermediary does not have economic substance; • and/or the tax agency considers it appropriate
	The condition by which the exporter and the intermediary trader and/or the actual intended recipient of the goods are related parties may be established in some countries, but not in all. At least one country (Brazil) applies the method whenever the foreign company is resident in a listed jurisdiction (non-cooperative, low tax jurisdiction, or under a privileged tax regime), regardless whether the companies involved are related enterprises.
C	The condition that there needs to be an international intermediary having no economic substance for the measure to be applied is expressly established in some countries, while it is not a requisite in others
	• Mandatory if the conditions established in the regulation are met; • Optional, either this measure or the CUP method may be applied; • Not expressly established by the regulation

- The higher price between the quoted price of the goods in the transparent market on the day they are loaded (for shipment) and the price agreed upon with the intended intermediary;
- Export and imports are afforded different treatment;
- For exports: research on international prices in accordance with the terms agreed upon by the parties as of the last shipment date unless there is evidence that it was agreed on another date;
- For imports: the price may not exc

	agency a few days after it has been signed.
C	Some countries allow for comparability adjustments to the publicly available price so as to take into account market circumstances, contract terms and conditions, and product quality and specifications whereas other countries no not accept comparability adjustments.
E	Some measures implemented in the region provide the local taxpayer with the possibility to evidence that the intermediary has economic substance, even though the criteria are not the same in every case.

B.3.4.2.1.5. Considering that the arm's length principle requires prices between associated enterprises to be comparable with those used between unrelated parties, it would generally be required that market prices be used that would apply in the same or similar circumstances as those that apply to the transaction between associated enterprises. Where the sixth method offers taxpayers the opportunity to provide evidence that the intercompany transactions are not abusive and the prices are at arm's length, and the method

(ii) quoted prices can be used under the CUP method, subject to a number of considerations, as

B.3.4.3.1.4.

parties. It also notes that a main problem encountered is the difficulty in assessing useful and

tax authorities try to obtain an understanding of the value chain related to the commodity and its subsequent processing or transformation, to help with determining the arm's length compensation for the functions performed and risks incurred by the entities involved in that value chain.

B.3.4.3.3.C

B.3.4.3.3.1. Use of the sixth method offers some benefits but also carries with it some disadvantages as discussed above. The sixth method, in its most rudimentary form, operates as a price-setting mechanism that may roughly resemble the CUP method. However, depending on how it is applied, it may not meet the rather strict requirements that the CUP method traditionally requires for its application. Some countries consider it a benefit that the method can be used when no exact transfer price or comparable transaction is available for the commodities or products involved. This approach may serve as a practical means to raise revenue and requires relatively limited audit activity related to taxpayers engaged in intercompany commodity trading activities. A disadvantage of the approach is that, depending on how the sixth method is applied, there is a potential risk of divergence from the arm's length principle and double taxation. Another disadvantage of the approach is that it does not apply a traditional transaction method or traditional profit based method and hence may not be recognised by the country at the other end of the transaction. As a country's tax system and tax authorities develop and benefit from more transfer pricing-related know-how and resources, the sixth method may not or may no longer be necessary, or it may be adjusted or updated to allow countries to achieve greater consistency with the arm's length principle.

B. 3. 2 2 5 6 3.43 4 1 1 4.1 3 6 1 4 4 5 5 5 4 3 1

contracts, other relevant variables, the delivery date and conditions (CIF, FOB etc.) and whether the transaction between the associated enterprises is carried out at the same level of the supply chain as the one that served to set the publicly available price.

B.3.4.3.3.4 As stated earlier, the application of the sixth method in some countries is generally conditioned on the lack of (evidence on) substance of the intermediary trading entity. To the extent taxpayers may provide evidence on the substance of (their associated) intermediary entities and based on adequate evidence can opt out of the application of the sixth method, it could be expected that taxpayers will make an effort to provide the requisite additional information and the more accurate and arm's length the income allocation may become that applies between the associated enterprises.

B.3.4.3.3.5. Allowing for evidence or proof of substance is not uncommon with this approach. Doing so adds an administrative burden on taxpayers and tax authorities, however. As an example, one country's law and regulations provide in relevant part:

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sixth method (if and when it refers to intermediaries), specifying the transactions subject to the sixth method and specifying the criteria for its application will assist in reducing uncertainty and potential tax disputes. To the extent taxpayers can provide evidence as regards to the needed substance of intermediaries and what would constitute an arm's length price, the legislation includes adjustments to the publicly available commodity prices to assure improved comparability, the sixth method becomes more sophisticated and in line with the arm's length principle. Taxpayers may benefit from (improved) access to avoidance of double taxation in that event as well.