INTERNATIONAL TAXATION

TRANSFER PRICING METHODS

PART II

TRANSACTIONAL PROFIT BASED METHODS

INTRODUCTION

- The lack of widely available benchmarking data may lead taxpayers to apply profit-based methods in preference to other methods which require information on **open-market prices** of **comparable transactions**.
- A Transactional Profit Method looks at the **profits** that arise from particular controlled transactions.
- Just like the Traditional Profit Methods (CUP, RPM & CPM) they are used to **approximate** arm's length conditions

INTRODUCTION

- These methods differ from the tradtional methods in that they look at the net profit rather than the gross profit.
- Transactional methods may be applied when one or more of the associated enterprises contributes valuable intangible assets as an appropriate return for the use of those intangibles must be determined.

TRANSACTIONAL TP METHODS

- Transactional TP methods use net profitability to test transfer pricing.
- Net profit = Gross profit (sales minus cost of goods sold) - **operating expenses.**
- Operating expenses should exclude interest and taxes.
- **"Operating profit" (Earnings Before Interest and Tax - EBIT)** is a better term than "net profit",
- This is because net profit is also used to represent the profit of a company after interest and taxes have been subtracted.

TRANSACTIONAL NET MARGIN METHOD (TNMM)

- TNMM compares the net profit earned by the tested party of a controlled transaction with the net profit earned in uncontrolled transactions.
- Relies on the principle that functionally similar companies operating in the same market tend to make similar returns over time.
- It is similar to RPM and CPM – it is one-sided and allocates residual profits to the other party
- Different as it compares net indicators leading to significant differences between the methods.

TNMM … cont'd

- Primarily used based on external comparables
- It compares **the net profit margin** attained by an entity in a related party transaction to those attained by independent entities relative to some **appropriate base** such as return on total costs, operating profit to net sales ratio, or return on assets
- Depending on the functional profile of the tested party different profit level indicators (PLI) will be used

TNMM … cont'd

- Other bases may include;

1. Operating margin (Operating Profit/Sales)
2. Net Cost Plus Margin (OP/Operating Exp + COGS)
3. Berry ratio (GP/Operating Expenses)

When to use TNMM

1. When the two related parties engage in a continuing series of transactions and one controls intangible assets which an arm's length return is not easily determined.
2. In situations where data limitations on uncontrolled transactions make it more reliable than traditional methods.
3. If available comparables differ significantly with respect to products and functions,
4. If data to perform a gross margin method is not available.
5. In practice TNMM is used by tax authorities to identify companies for audit by analysing their net profit margins

TNMM Illustration

- AGA AB is a Swedish manufacturer of cookers. All AGA AB cookers are sold to an overseas associated enterprise, Axis Ltd, and bears Axis Ltd's brand.
- Axis Ltd, a household electrical appliances brand name, sells only cookers manufactured by AGA AB.
- After the appropriate functional analysis, AGA AB was able to identify a Swedish manufacturer of home electrical appliances, Sandvik AB, as a suitable comparable company.
- However, Sandvik AB performs warranty functions for its independent wholesalers, whereas AGA AB does not. Sandvik AB realizes a net mark up (i.e. operating margin) of **10%**.

TNMM Illustration

- Available information from AGA AB's financial statements

1. cost of goods sold $ 10,000
2. Operating expenses $ 2,000

- What is the transfer price for AGA AB's sale of cookers to Axis Ltd? is computed using the TNMM as follows:

Strengths of TNMM

1. Flexibility and simplicity in application
2. Availability of information as it relies on external comparables
3. One-sided – easier to conduct a comparability analysis
4. Can be used as a second method to ensure transactions are at arm's length
5. Net profit indicators may be more tolerant to some functional differences than gross profit margins.

Weaknesses of TNMM

1. Overuse and oversimplification.
2. One-sided testing and creation of profit as one party is guaranteed a certain positive profit level
3. It ignores many business factors that do not have an effect, or have a less substantial or direct effect, on price or gross margins.

Profit Split Method (PSM)

- Aims to split the total profit earned on a transaction by all the group companies involved in it using an 'equitable' formula.
- This method seeks to eliminate the effect on profits of special conditions made or imposed in a controlled transaction(s) by determining the division of profits that independent enterprises would have expected to realize from engaging in the similar transaction(s)
- It is a two-sided method, useful when both parties are non-routine

PSM … Cont'd

- It is applicable if no other method can be applied and;

i. Parties to the transaction make unique and valuable contributions

ii. Business operations are so highly integrated and contributions by the parties cannot be evaluated separately, or

iii. Parties to the transaction share economically significant or closely-related risks.

PSM … Cont'd

- Application is dependent on external comparables which in practice are rarely available
- Thus it is the only OECD method that can be used without comparables, solely relying on the parties' contributions to the transaction.

PSM … Cont'd

- PSM is applied in two steps;

1. Determine the profit to be split –

- Generally, the profit to be split is the operating profit

2. Split the profit on an economically valid basis reflecting the relative contribution of the parties.

- Applies to losses as well

PSM … Cont'd

- The common approaches to applying the second step are
- the **residual analysis** approach and
- the **contribution analysis** approach

PSM … Cont'd

Residual Analysis Approach

Combined profits from the controlled transaction are allocated based on a 2-step approach

1. Parties to the transaction are allocated remuneration for their less complex, easily benchmarked functions
   - This can be benchmarked using any of the traditional methods or TNNM and does not include compensation for unique and valuable contributions.
2. Residual profit allocated based on the relative value of the valuable and unique contributions of the parties.

Contribution Analysis

- Under this approach profits are allocated to the parties based on the relative value of the valuable and unique contributions of the parties
- The combined net profits from the controlled transactions are divided between the associated enterprises based on:

1. A reasonable approximation of division of profits that independent enterprises would have expected to realize from engaging in comparable transactions or;
2. functions performed by each of the associated enterprises participating in the controlled transactions, taking account of assets used and risks assumed.

- It is similar to step 2 on the Residual analysis

Contribution Analysis Steps

1. Compute combined net profit
2. Examine functions (routine, non-routine functions, intangibles – where intangible is one sided) -FAR
3. Determine relative value of each function
4. Examine external data where available and reliable
5. Assign a profit split percentage for each function, then aggregate for each party.
6. Work back to a transfer price

Residual Analysis v Contribution Analysis

- Residual PSM used more often for 2 reasons;

1. It breaks up a complicated transfer pricing problem into 2 manageable steps
2. The relative value of the contribution of each party is often more difficult to quantify when one attempts to divide the total profit directly.
3. Potential conflict with the tax administration is reduced by using the 2-step approach as it reduces the amount of profit to be split in the potentially controversial second step.

PSM Illustration

- Goode UK is a British manufacturing and sales company for telecommunication products. It has developed an original microprocessor and holds the patent for the manufacturing technology.
- Artemis Plc, an overseas subsidiary of Goode UK, develops and manufactures mobile equipment using the new microprocessor as well as technology developed by itself.
- Artemis Plc is the only manufacturer licensed by Goode UK to use the new microprocessor.
- Goode UK purchases all of the mobile equipment manufactured by Artemis Plc and sells them to third parties.

PSM Illustration…Cont'd

- As the nature of the products are very advanced and unique, the group is unable to locate any comparable with similar intangible assets.
- However, the group is able to obtain reliable data on mobile phone contract manufacturers and equipment wholesalers without unique intangible property in the telecommunication industry.
- The manufacturers earn a mark-up of 10% while the wholesalers derive a 25% margin on sales.

PSM Illustration…Cont'd

- The simplified accounts of Goode UK and Artemis Plc are shown below:

	Artemis	Goode
Sales	100	125
Cost of Goods sold	(60)	(100)
Gross margin	40	25
Sales, General & Admin expenses	(5)	(15)
Operating Margin	**35**	**10**

PSM Illustration…Cont'd

- On further study of the two companies, two particular expense items, R&D expenses and marketing expenses, are identified as the key intangibles critical to the success of the mobile equipment.
- The R&D expenses and marketing expenses incurred by each company are:

Company	$
Goode UK	12
Artemis Plc	3

- Determine the Transfer price

PSM Strengths

1. Can offer a solution for highly integrated operations for which one-sided approaches are not appropriate
2. Provides a more reliable result if both parties to the transaction make unique and valuable contributions
3. Suitable where no comparable transactions are available
4. It is a two-sided approach

PSM Weaknesses

1. Calculation of combined profit may be complicated due to variations in accounting practices, lack of segmented financials
2. Contribution analysis can be highly subjective and is often scrutinized by tax authorities
3. Profits arising today may be the result of work undertaken by one of the parties' many years in the past.

Transfer pricing methods

TP Method	Key considerations	Applicable transactions
Comparable Uncontrolled Price	▪ High level of product comparability. ▪ Often not appropriate where the transaction is influenced by existence of intangible assets. ▪ Comparability adjustments are often necessary to enhance its reliability.	Any controlled transactions as long as it can reliably be established.
Cost Plus Method	▪ A reasonable degree of product comparability is required. ▪ Sufficient information on functions undertaken is relevant. ▪ Accurate determination of cost of activities.	▪ Service transactions ▪ Manufacturing transactions

Transfer pricing methods

TP Method	Key considerations	Applicable transactions
Resale price method (RPM)	▪ A reasonable degree of product comparability is required. ▪ Sufficient information on functions undertaken is relevant. ▪ Accurate determination of sales to end customer.	Sales and distribution activities.
Transactional Net Margin Method (TNMM)	▪ Emphasis on comparability in processes and functional analysis. ▪ Segmentation of results is vital.	Applicable to different transactions depending on the selected profit level indicator e.g. Cost, sales, Capital Employed.

Transfer pricing methods

TP Method	Key considerations	Applicable transactions
Profit Split Method	▪ Existence of highly integrated/ intertwined processes between the associated persons. ▪ Each party to the controlled transactions make unique and valuable contribution (functions, assets) to the transaction. ▪ Determination of the overall/combine profit to be shared in vital. ▪ Determination of splitting factor.	Applicable where one-sided methods are not appropriate and where factors for its use can reliably be determined.

Questions?