



Mr. Jeffrey Owens,
Director of the OECD Centre for Tax Policy and Administration
Organisation for Economic Cooperation and Development
2, rue André Pascal
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Paris, April 2008, 30th

Subject: invitation to comment on a series of draft issues notes in relation to transactional profit methods

Dear Mr Owens,

We are pleased to enclose a response from TAXAND's Global Transfer Pricing Team to the call for comments issued by the OECD Centre for Tax Policy and Administration on a series of draft issues notes in relation to transactional profit methods. We appreciate the opportunity to share our views on the issues investigated by the Working Party.

TAXAND is a global network of more than 2,000 leading tax advisors across 43 countries. Our Global Transfer Pricing team brings together experts from across our independent member firms to share knowledge, best practice and global client service delivery. Working together we have pooled a wealth of transfer pricing experience to collate our attached TAXAND response.

For the sake of clarity we have organised our comments according to the presentation of your draft report. We are pleased to authorise the OECD to publish these comments on its website or in any publications.

We would of course be happy to provide you with any additional information. Please do not hesitate to contact me on +33 (0)1 70 38 88 28 or at antoine.glaize@arsene-taxand.com.

Yours sincerely,

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The comments attached result from analysis undertaken by the above individuals and do not necessarily reflect the views of any TAXAND Member Firms.

TRANSACTIONAL PROFIT METHODS

TAXAND COMMENTS TO THE DISCUSSION DRAFT ISSUED BY THE ORGANISATION
FOR ECONOMIC CO-OPERATION AND DEVELOPMENT ON 25 JANUARY 2008

30 APRIL 2008

The below sections provide for the TAXAND common answer to the Discussion Draft issued by the OECD on 25 January 2008 (hereinafter "The Discussion Draft").

1. REVIEW OF TRANSACTIONAL PROFIT METHODS: STATUS AS LAST RESORT METHODS

From practical experience, transactional profit methods are now the most widely used methods by taxpayers as well as tax administrations. As a matter of fact, due to unavailability of reliable comparable data, the traditional transaction methods in most cases could not produce reliable result and thus are rarely used in practice.

We accordingly agree that transactional profit methods should no longer be regarded as the "last resort methods" that only apply in exceptional cases, but should play a more important role. As stated in the Discussion Draft one should always select a transfer pricing method that is most appropriate to a particular case, meaning the application of the selected method should produce the most reliable result for the case at hand.

While, theoretically speaking, there is still preference of traditional transaction methods over transactional profit methods, we still hold the view that in practice, they should be considered as equally important the selection of the method should then be led by the specificities of the case. In this respect we consider that availability of sufficiently reliable information is also a key factor in assessing what should be the most appropriate transfer pricing method to apply.

This however should not lead to a situation were transactional profit methods would be systematically preferred, taxpayers holding the privilege to decide what is the most appropriate method and tax administrations being then committed to demonstrate the non-appropriateness of the selected method if they wish to substitute an alternative one.

In this regard, we consider that it is in practice very difficult and arguable to determine what is the most appropriate method and therefore, we feel that the OECD position should be that either a method is appropriate, given facts and circumstances, and it is acceptable i.e. there should be no possibility for the tax authorities to substitute an other one or it is not appropriate and the tax authorities should bear the burden of this proof.

2. USE OF MORE THAN ONE METHOD (USE OF A TRANSACTIONAL PROFIT METHOD IN CONJUNCTION WITH A TRADITIONAL TRANSACTION METHOD, OR SANITY CHECK)

A- Use of a transactional profit method in conjunction with a traditional transaction method

The Discussion Draft proposes the use of a transactional profit method in conjunction with a traditional transaction method in cases such as the following:

- Where there is no single sufficiently reliable comparable but multiple sources of data that can be used by applying more than one method
- When it is unclear as to which method provides the most reliable result
- Where a transaction takes place in a country that accepts transactional profit methods and one that does not

In the above stated situations, when two or more methods generate the same results, use of more than one method can help both the taxpayers and the tax administrators to come to plausible conclusions. However, use of multiple methods in some cases may give rise to inconsistencies and increase the onus on taxpayers for providing greater information. The Discussion Draft provides limited guidance to deal with such issues. This is enumerated below:

- In cases where sufficiently reliable comparable information for application of more than one method is available, the Discussion Draft suggests that all such methods should be relied upon. Limited guidance is available on what can be done when use of more than one method provides differing results.
- The Discussion Draft purports use of more than one method only in appropriate cases. This may encourage taxpayers to use a second method only when favorable to their case. The Discussion Draft is silent about whether it is required for a taxpayer to demonstrate the requirement or otherwise for application of a second method when the same is not used for the analysis.
- Use of more than one method may encourage tax administrations to request for additional information from a taxpayer for application of a second method. Limited guidance is available on the circumstances under which the Revenue authorities can insist on application of a transactional profit method in conjunction with a traditional transaction method.
- The Discussion Draft also does not address the issue in relation to burden of proof for application of a transactional profit method in case the same is not relied upon in the analysis provided by a taxpayer.

B- Use of a sanity check to test the plausibility of the outcome of a primary method

The Discussion Draft purports that a secondary method can be used as a check to establish whether a primary method is the most appropriate method and whether it is appropriately applied. In situations when the results derived from use of a second method corroborate the results of the primary method, it immensely helps both the Revenue authorities and the tax payers by serving as additional evidence in support or otherwise of the transfer prices adopted.

However in this regard it is also important that the OECD guidelines address any inconsistencies that may arise as enumerated below:

- A secondary method by nature shall not be the most appropriate. Thus, it may not always be the best to rely on the results obtained from use of such method. The Discussion Draft purports that use of a secondary method can lead to re-examine whether the comparability analysis undertaken in application of a primary method was appropriate. There can be instances where a secondary method may lead to a result different from that obtained by application of a primary method. When it is uncertain whether the results obtained by use of secondary method itself are correct, questioning the comparability analysis while application of the primary method may be invalid.
- The Discussion Draft suggests that when use of a secondary method confirms that a primary method is the most appropriate method, the results obtained from the primary method should not be rejected. For practical purposes, more guidance is sought on how a confirmation on whether a primary method is the most appropriate can be made.
- Use of more than one method that generate differing results most often than not shall lead to differing positions between a taxpayer and the revenue authorities.
For instance, in case appropriate information for application of Comparable Uncontrolled Price (“CUP”) method is available, and the taxpayer at the net level is incurring losses, limited guidance is available on whether reliance should be placed on analysis using Transactional Net Margin Method (“TNMM”) or not. Paragraph 33 of the Discussion Draft correctly recognizes the limitation of relying on a secondary method. Guidance is needed on how to overcome the issue.
- Use of more than one method may encourage Revenue authorities to request for additional information to support use of a primary method applied by a taxpayer. Such information may not always be available with taxpayers and would thus increase the compliance burden on them.

For example, in case of a manufacturer, a gross margin analysis using Cost Plus Method (“CPLM”) may be corroborated using TNMM. In doing so the factors for selection of comparable companies under both the methods may

differ. Net margins of the identified comparable companies under CPLM may not be the most appropriate for application of TNMM. A new benchmarking analysis may be required, increasing the onus on taxpayers. It is thus important that the OECD guidelines also address the issue of burden of proof in such cases.

Guidance should be provided on whether it is important for the Revenue authorities to demonstrate errors in the analysis adopted by a taxpayer for adoption of a secondary method or to request for additional information in support of a secondary method. Elaboration on the circumstances in which additional information can be sought by the Revenue authorities shall be helpful.

- The Revenue authorities may require that analysis using a secondary method be undertaken on a year on year basis. Greater guidance is required in cases where the results of the analysis are favorable in one year but not in subsequent years.
- In cases where a transactional profit method is used with another transactional profit method, for instance when the conclusion arrived by use of TNMM is corroborated using Profit Split Method (“PSM”), as given in paragraph 38, an irrational outcome may be obtained. For example, TNMM may lead to a cost plus mark-up of 10 percent to be earned by a subsidiary whereas using a profit split method may lead to the subsidiary being accountable towards sharing a part of the Group losses. Although the Discussion Draft purports that in such a situation the results as obtained by use of TNMM are to be accepted, it may not be commercially feasible. It should be based on the facts and circumstances of a case whether PSM can be relied upon to test the results of TNMM. OECD may consider providing greater guidance on such circumstances.

C- Summary of observations

To summarize the above points, though theoretically use of a secondary method may help both the taxpayers and the tax administrators to corroborate an analysis undertaken using a primary method, greater guidance is required in relation to the following points:

- How can a judgment be made on whether the results obtained by application of the secondary method are reasonable?
- In case differing results are obtained by use of a secondary method, when should the primary method be accepted or further analyzed?
- In cases where a taxpayer has relied upon only one method, whether it is important to demonstrate that a secondary method is not applicable / required?
- In cases where the taxpayer has relied upon only one method, who bears the burden of proof for use of a secondary method?
- To what extent can the Revenue authorities question the use or otherwise of a secondary method?
- Can the Revenue authorities purport the use of a secondary method even when it is not applied by the taxpayer?

- To what extent can the information be sought by the Revenue authorities from the taxpayer for application of the secondary method?

At present, in most countries a kind of hierarchy exists in the determination of the applicable method for transfer pricing analysis. Typically a traditional transaction method is applied as the 'method of first choice' and a transactional profit method is only used to 'approximate' the arm's length standards. Thus, for application of more than one method to be acceptable in various jurisdictions, greater guidance is sought from OECD. It is also observed that in jurisdictions where there exists a 'one method' rule, the use of one method shall override even in the situations stated in the Discussion Draft.

Furthermore similar observation as the ones that have been made regarding the hierarchy of the methods, possibility to use a corroborative method should be open to taxpayers in order to better support their position and improve their transfer pricing documentation and in no case it should be an obligation. In particular guidance should be provided that use of a secondary method should never overcome the use of the primary method as long as the tax authorities have not demonstrated the primary method is not appropriate? It should in particular be stated that the fact the secondary method is not consistent with the primary one will not be a sufficient to invalidate the primary one.

3. ACCESS TO THE INFORMATION NEEDED TO APPLY OR REVIEW THE APPLICATION OF A TRANSACTIONAL PROFIT METHOD

The chapter gives a description of the nature of information that should be maintained by a taxpayer and which can be sought by Revenue authorities at the time of audit. Although the circumstances provided by the Discussion Draft and the nature of information sought is reasonable, following are certain open issues that need to be addressed further:

- Specific information that may be sought for application of each method
- Extent to which information on non tested party can be sought by the Revenue authorities
- In case a foreign party is taken as the tested party, nature and extent of information / documentation that can be sought by the Revenue authorities
- Extent to which information is required to be maintained by small and medium enterprises

4. APPLICATION OF TRANSACTIONAL PROFIT METHOD AND UNIQUE CONTRIBUTIONS

This chapter brings out the various ways “unique contributions” and intangibles can be valued and tested. The Discussion Draft emphasizes the importance for use of traditional transaction methods when appropriate information is available. However, in practice it is observed that in most cases internal comparables are not available and transactional profit methods are relied upon as the most appropriate method in a given case by the taxpayers to test the arm’s length nature of transactions involving intangibles.

The Discussion Draft purports the use of TNMM as a sanity check in certain cases, which may not be practical. Where TNMM is used as a sanity check and results in a different outcome from that obtained by the application of a primary method, limited guidance is available on how such situations can be dealt with.

In most cases, it may be questionable as to which method should be relied upon given that none of the methods (barring CUP) provide a true indication on value of the intangible. Valuation of intangibles often requires expertise that may be beyond the application of one of the five methods.

The Discussion Draft provides limited guidance vis-à-vis valuation of intangibles and testing the arm’s length nature of intangibles. In this regard, for valuation / benchmarking purposes, it is purported that the following should be taken care of:

- Recognition of the ownership of intangibles
- Risk sharing between parties engaged in development of intangibles
- Expected benefits of the parties involved including consideration for losses where applicable
- Research and development activities carried on in the initial years before the development of intangibles
- Method adopted by the related enterprises for transfer of intangibles eg outright sale for consideration, outright transfer for no remuneration, license in exchange of royalty, royalty free license etc
- Nature of intangibles – marketing intangibles, trading intangibles, hybrid intangibles

It is important that due consideration is given to the above factors before a method is adopted for the purpose of valuation / benchmarking. The OECD guidelines should elucidate with the help of appropriate examples on how the factors should be considered in practice vis-à-vis use of different methods by taxpayers.

5. APPLICATION OF THE TRANSACTIONAL NET MARGIN METHOD: STANDARD OF COMPARABILITY

A- Comparability analyses and TNMM: General Considerations

Paragraph 3.34 of the 1995 OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations indicates that “prices are likely to be affected by differences in product, and gross margin are likely to be affected by differences in functions, but operating profits are less adversely affected by such differences...”

Arm's length principle is generally based on Comparison. Comparing operating margins applying TNMM comparability in functions, risks and economic circumstances take on special importance. In this order of ideas, finding functional comparable financial information must be the objective.

The conclusions of the Working Party regarding the depth of the comparability analysis look reasonable and we agree that the requirement for a detailed analysis regarding comparability of the transactions should be adapted to the facts and circumstances in particular whether it relates to third party transactions or to taxpayer's own transactions.

B- Comparability factors and the transactional net margin method

Less important when applying TNMM is the comparability on the kind of property or services transfer when the most important issue to observe is how the transaction was made, identifying function and risk taken in order to find comparable financial information. Functional analysis is the base for transfer pricing TNMM economic analysis. From functional analysis, practitioners can appreciate the kind of risk that the company is bearing.

As said in Paragraph 3.27 “... Differences in the function performed between enterprises are often reflected in variation in operating expenses...” In this order of ideas the abovementioned subjective appreciation obtained on the functional analysis should be verified with objective analysis based on numbers and figures from tested party (TP) and comparable companies (CC). Our affirmation can be validated in illustration 1 of the Discussion Draft, where case 1 and 2 are different by marketing expenses.

It is also important to mention that other ratios can provide useful information. Ratios calculated from the balance Sheet can show how companies perform their activities and provide information on economic aspects. For example an indicator from TP that has fixed asset to sale of 60% vs. 20% of CC could lead us to the conclusion that there is no comparability based on differences from risks undertaken or TP is not using full capacity.

Most of the economic circumstances to take into account are reflected in the 1995 Guidelines. Profitability analysis over a long period of time is more accurate than a

one year analysis. In fact it helps to reduce market and some contractual terms differences.

We agree with the analysis of the Working Party that compatibility adjustments can be made to account for comparability differences in order to compare profit indicators. In this respect several non exhaustive comments can be made:

- In order to apply any adjustment, actual information and not theoretical information should be favored. For example, if an economic recession made a company employ 50% of its full capacity, adjustment to fix cost cannot be done to theoretical capacity unless the company had reached those levels of production. However in certain circumstances it might not be possible to have access to actual information ; further guidance should be provided as to how the adjustments should be conducted.
- Notwithstanding the possibility to make adjustments in order to aim more accurate comparability, it should be reiterated that the use of an inter-quartile range should remain accepted as it actually reflects the existence of comparability differences which are in many circumstances impossible to circumvent with reliable adjustments.
- More specifically local situations may affect the ability to perform detailed comparability analysis: for instance financial information regarding companies is very restricted in developing countries. Applying a TNMM with “comparable” financial information from developed countries is a normal practice; however comparability standards have to be reviewed. In this sense, there are accounting differences that should be eliminated using operating profit analysis. It is also common to find higher gross margins in developing countries undergoing inflation levels. Higher margins will ensure the company buying inventory again. Inflation levels must be observed while applying working capital adjustment.

C- Aggregation, segmentation of transactions with the transactional net margin method. Portfolio approaches

The 1995 Transfer Pricing Guidelines contain some discussion of the comparability standard to be applied to the transactional net margin method (see paragraphs 3.34 to 3.40).

Aggregation matters must be analyzed under the TNMM both at the level of the tested party and the comparable parties.

As for the tested party, according to our own experience, the use of the TNMM should allow functional and economically linked transactions to be taken into consideration in an aggregated manner.

A functional link would entail that the benefit for the recipient of a given product or service shall be assessed along with the joint supply of other related products or

services, to the extent that the first-mentioned product or service would not necessarily be commercialized on an independent basis. For instance, a company may need to commercialize jointly a machine and the consumables used in said machine (e.g. coffee machines and coffee capsules, or printers and cartridges).

Other example would be the sale of specific hardware/software along with the provision of support and technical services related to the use of said hardware/software. Both business flows may be valued jointly to the extent that the provision of one depends on the supply of the other.

Finally, the license of various types of industrial/commercial IP is often linked in a functional manner, so that it is difficult to differentiate the various concepts embedded in each type of IP, and even more its separate valuation. (e.g. the licence of a franchise may include different items such as branding, credential, know-how, etc.).

The economic link, on the other hand, expresses the situation in which a company sells two or more products or services jointly due to a particular commercial strategy. For example, a company might have the strategy of selling a certain product that produces minimal profit or even a loss in consideration of which it is able to sell other more profitable products or services, obtaining in the overall aggregated transactions an adequate profit taken as a whole. Alternatively, under this scenario, if the company commercialized the products separately the overall aggregated profit of the company could be lower (since, e.g. the less profitable product cannot be sold at the same price on a stand-alone basis).

Another example would be the case of companies investing in numerous R&D projects, out of which only a few will become successful: Economic-wise, the successful projects must pay back the aggregated investment made by the company in all its R&D activities (otherwise the company would not engage in said activity viewed as a whole).

Other situations, in which taxpayers value on an aggregated manner various intra-group transactions, may require a separate valuation approach in order to assess their arm's length value. In this regard, it would be useful for tax practitioners to obtain further indication from OECD as regards to the facts and circumstances under which the functional/economic link between various intra-group transactions carried out by the tested party may require/deserve an aggregated valuation approach versus those in which a separate valuation approach would be more adequate under the arm's length principle.

Secondly, as for the comparable parties, the use of company-wide aggregated data might be appropriate to the extent that said comparable party conducts exclusively (or almost) a single activity corresponding to the one carried out by the tested party.

Considering the limited access to third parties' public comparable information, it would be useful for tax practitioners if the OECD could establish more accurate guidelines as regards to materiality principles for assessing when the comparable

companies may be deemed to perform a single activity, despite of conducting other transactions in a marginal way.

Apart from this, the comparability analysis should focus not only on the fact that the tested company and the comparable company conduct identical or analogous activities, but also on the fact that such activities are carried out in a similar way (e.g. using the same level of fixed assets or financial resources or under the same or similar market conditions). In this context, it would be ideal if further analytical information regarding these issues could be collected from public sources)

It would be useful if the OECD TP Guidelines could provide further and more specific guidance on these subjects.

6. APPLICATION OF A TRANSACTIONAL NET MARGIN METHOD: SELECTION AND DETERMINATION OF THE NET PROFIT MARGIN INDICATOR

Based on the underlying assumption that any situation should be considered depending on facts and circumstances we consider that the analysis of the Working Party regarding the various expenses items to be taken into account or not in the tested profit indicator is reasonable.

The decision in this respect should ultimately result from the appreciation whether the considered expenses items affects from an economic analysis standpoint the overall profitability of the operation or whether it reflects the materialisation of a risk that third parties dealing together would agree upon its "affectation" and eventual compensation.

Furthermore as regards the choice of the most appropriate denominator we agree it should be consistent with the comparability analysis and reflect the allocation of risks among the parties and even more importantly the value drivers of the transactions. Nevertheless the choice of the denominator should not be pre defined depending on the type of transactions but should rather result from a facts and circumstances case by case analysis. It might be the case that different denominators might be relevant (i.e. sales or operating expenses for a distributing activity). In any case we also agree that the denominator should be of nature not affected by the transfer pricing formulation.

Notwithstanding the above comment in any case, the profit level indicators should be computed only taking into account the items related to the intragroup transactions which are to be tested.

As a general conclusive comment on this section we consider it is of foremost importance to define profit level indicators, transactions by transactions, which are highly reflective of the characteristics of the transactions and their value drivers. In any case once the transactional profit method has been retained and the profit level indicator has been defined the burden of the proof should rely on the tax authorities to challenge and potentially disregard the profit indicator on which the taxpayer has ground its transfer pricing method.

7. APPLICATION OF A TRANSACTIONAL PROFIT SPLIT METHOD:
DETERMINATION OF THE COMBINED PROFIT TO BE SPLIT

In order to discuss the use of the profit split method we would like to make some introductory the following comments related to the use Transactional Profit Split Method:

- Taxand experience of the usage of profit split is limited to cases of complex or non-routine IP. Where the profit split is applied, the residual profit split is most commonly used.
- Even though in most jurisdictions, tax authorities accept this method in principle, however, they favor traditional methods over the profit split. This is mainly due to this method's relative complexity and subjectivity which require particular i) expertise and practice from the tax authorities and ii) pertinent documentation from the taxpayer.
- Tax administrations may often attack transfer pricing structures with the profit split concept as a first instance as it represents the maximum possible adjustment- however, the OECD guidelines are clear that a revised structure can only be applied in exceptional circumstances. However due to its difficulty of application the resulting approach agreed upon after negotiation is most often a cost plus or TNMM.
- With more standard transactions, businesses will tend to use the TNMM above the profit split method due to it's ease of application, accuracy, and more direct applicability to the theory of arm's length due to it's assessment of true third party transactions. For example this will be typically seen in the manufacturing industries.
- Recent past also shows an increasing use of this method by taxpayers and therefore, a facilitated approach towards tax authorities.

One of the main issues businesses face is calculating the combined profit and translating two accounting methods into one. Where it is generally accepted that IFRS is the standard used for this calculation, its usage would still require explanation to the local revenue.

A common accounting standard is critical to a profit split analysis; many countries apply accounting standards that depart from IFRS and the calculation of a universal profit can be difficult to undertake and for the local tax administrations to conceptualise.

In many countries, there would be significant accounting translation efforts required which would in turn need detailed documentation. In addition, we do not advocate measures that will increase the administrative burden on taxpayers.

- It is common for the application of the profit split to see a removal of exceptional items when calculating it.
- From our experience we would also expect to see a difference in adjusted items used across industries, in particular in relation to depreciation.

8. APPLICATION OF A TRANSACTIONAL PROFIT SPLIT METHOD: RELIABILITY OF A RESIDUAL ANALYSIS AND CONTRIBUTION ANALYSIS

Our experience shows that the use of a residual analysis, whenever possible, enables to more precise arm's length pricing as far as only the value added / specific / non benchmarkable functions, risks or assets are split between the parties.

That being said, a residual profit split approach does not preclude from using a contribution analysis. Indeed, once the routine remuneration have been allocated to the related parties for their benchmarkable functions, the residual profit / loss is generally split based on an analysis of each parties' contribution to the value chain (as reflected in the functional analysis), i.e. a contribution analysis.

Therefore, we think that the current dichotomy between residual and contribution profit split should be revised.

Besides, in instances when a residual profit split is not applicable (e.g. when there is no benchmarkable functions or assets) a "pure" contribution approach would advantageously be based on a variety of contribution indicators (processes / functions, costs, assets, etc.). This is likely to mitigate the subjectivity risk inherent to profit split methods.

9. APPLICATION OF A TRANSACTIONAL PROFIT SPLIT METHOD: HOW TO SPLIT THE COMBINED PROFIT

In our experience, tax administrations often apply the residual profit split using a cost allocation for ease of application; this is contrary to the OECD guidelines which require an assessment of economic significance or value.

In practice we see an application of a cost basis from tax administrations as a PLI, particularly operating costs which needs to be treated carefully across industries and accounting standards. However, cost is considered to be a poor reflection of economic significance.

Although a cost basis is most easily understood by tax administrations, a value based PLI such as senior executive location, time or even senior executive cost allocations would be more in line with the arm's length principle.

In case of internal data used for the division of profits, the interviews with senior management as well as internal experts (for instance in the evaluation of R&D input) should be considered/indicated as one of reliable basis for valuation of particular supply chain participants' contribution to given processes/the business success as a whole.