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This is a working draft of a Chapter of the Practical Manual on Transfer Pricing for Developing Countries and should not at this stage be regarded as necessarily reflecting finalised views of the UN Committee of Experts on International Cooperation in Tax Matters or its Subcommittee on Transfer Pricing - Practical Issues. Comments in writing are sought and should be sent to the Secretariat to the UN Tax Committee at taxffdooffice@un.org by 23 November 2010 at the latest.

While several members of the Subcommittee have contributed to this draft and appropriate attribution will be made in a later version, the Secretariat particularly notes the contribution of Monique van Herksen.

Chapter 4 - Transfer Pricing Methods (Traditional Methods)

1. Introduction

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

1.1 Use of methods

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

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

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

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

1.3 Choice of available methods

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

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

2. Current methods

2.1.1 Comparable Uncontrolled Price

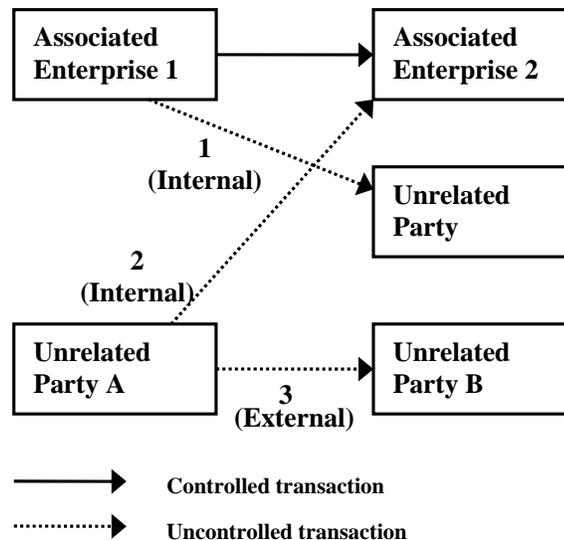
The Comparable Uncontrolled Price ("CUP") method compares the price charged for property or services transferred in a controlled transaction to the price charged for property or services transferred in a comparable uncontrolled transaction in comparable circumstances. The CUP method evaluates whether the amount charged in a controlled transaction is arm's length one by reference to the amount charged in a comparable uncontrolled transaction.

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

* Working Draft Editorial note: One possibility would be that taxpayers need not benchmark their transfer pricing with a formal benchmark search in cases where functions and transactions subject to the benchmark do not exceed a stated volume or amount on a fiscal year basis. The industry margins referred to should be: based on objective criteria, regularly updated and readily available at no cost. A possible example could be margins published or formally approved at the appropriate functional level of the UN system, but these do not currently exist.

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Figure 1: Comparable Uncontrolled Price Method



The controlled transaction in this figure concerns the transfer of cars between Associated Enterprise 1, a car producer in country 1, and Associated Enterprise 2, a car importer in country 2, which resells the cars to car dealers in country 2. Associated Enterprise 1 is the parent company of Associated Enterprise 2.

In applying the CUP method to determine whether the price charged for cars transferred in this controlled transaction is arm's length reference can be made to:

- The price charged for cars transferred in a comparable uncontrolled transaction, if any, between Associated Enterprise 1 and Unrelated Party (i.e. transaction #1);
- The price charged for cars transferred in a comparable uncontrolled transaction, if any, between Associated Enterprise 2 and an unrelated party (i.e. transaction #2); and
- The price paid for cars transferred in a comparable uncontrolled transaction, if any, between Unrelated Party A and Unrelated Party B (i.e. transaction #3).

Comparable uncontrolled transactions similar to transaction #1 or #2 can be referred to as internal CUPs. Comparable uncontrolled transactions similar to transaction #3 are called external CUPs, because the uncontrolled transaction involves two parties, neither of which is one of the Associated Enterprises.

The application of the CUP method based on internal CUPs involves a detailed transactional comparison, whereby the controlled and uncontrolled transactions are compared based on five comparability factors. The details of these transactions (contractual terms, the risks incurred and functions performed, economic circumstances) are necessary to perform such a comparison. Usually such details are not available when other methods (Cost Plus, Resale Price Method etc.) are being applied. The latter are usually applied using a benchmarking analysis (a search for comparable companies in publically available databases).

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2.1.2 Comparability

When applying the CUP method, an uncontrolled transaction is considered comparable to a controlled transaction if:

- There are no differences in the transactions being compared that materially affect the price; or
- Reasonable adjustments can be performed to account for product differences that are material and cancel out their effects.

In performing the comparability analysis the controlled transactions and uncontrolled transactions should be compared based on the comparability factors mentioned earlier [as addressed in an earlier chapter]. In determining the degree of comparability between controlled transactions in Figure 1 and uncontrolled transaction #1, for example, the following factors should be taken into account: characteristics of property or services, functional analysis, contractual terms, economic circumstances and business strategies.

Product comparability should be closely examined in applying the CUP method. A price may be materially influenced by assumingly minor difference between the goods transferred in the controlled and uncontrolled transactions, although the functions performed and risks assumed (e.g. marketing and selling function) are similar so as to result in similar profit margins. The CUP method is appropriate especially in cases where an independent enterprise sells products similar to those sold in the controlled transaction. Reference is made to the Coffee case example below.

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

Technically, there are two types of CUPs: Close CUPs and inexact CUPs. These are the result of (unrelated party) transactions that are adjusted to take account of material differences: close CUPs and inexact CUPs.

Reliable adjustments may be possible for:

- difference regarding the source of the products: unbranded Kenyan versus unbranded Brazilian coffee beans;
- difference in delivery terms: for example, Associated Enterprise 1 in Figure 1 sells similar cars to Associated Enterprise 2 and an Unrelated Party. All relevant information on the controlled and uncontrolled transactions is available to Associated Enterprise 1, and hence it is probable that all material differences between the transactions can be recognized. It is assumed that the circumstances relating to the controlled and uncontrolled transactions are similar. The only material difference that could be identified between the transactions is that the price relating to the controlled transaction is a delivered price (i.e. including transportation and insurance), while the uncontrolled transaction # 1 is made f.o.b. Associated Enterprise 1's factory (i.e. free on board – with the buyer taking responsibility from then on). It is possible to perform reliable adjustments for this

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difference. The uncontrolled price should then be adjusted for the difference in delivery terms to eliminate the effect of this difference on the price;

- volume discounts: for example, Associated Enterprise 1 sells 5000 cars to Associated Enterprise 2 for €20,000 per car, while it sells 1000 similar cars to an Unrelated Party. It should be analyzed whether differences in volume have a material effect on price, and if so, how to perform adjustments by examining volume discounts in similar markets;
- minor product modifications: for example, the uncontrolled transactions to an Unrelated Party in Figure 3 involve cars on which minor product modifications have been made. However, the cars sold in the controlled transactions do not include these product modifications. If the minor product modifications have a material effect on price, then the uncontrolled price should be adjusted to take into account this difference in price.
- risk incurred, for example, Associated Enterprise 1 carries inventory risk related to sales by Associated Enterprise 2 and bad debt risk as regards customers of Associated Enterprise 2, whereas as between Associated Enterprise 1 and Unrelated Party, the Unrelated Party carries inventory risk and bad debt risk as regards its customers. It should now be analyzed and quantified what the effect of the risk allocation is before Associated Party 2's margins and Unrelated Party's margins can be considered comparable.

Reliable adjustment may not be possible for:

- trademark: for example, Associated Enterprise 1 in Figure 1 attaches its valuable trademark 'Ferrori' on the cars transferred in the controlled transaction, while uncontrolled transaction #1 concerns the transfer of cars without the trademark 'Ferrori'. It is known that the effect of the trademark on the price of the car is material. However, it will be difficult, if not impossible, to perform an adjustment to account for the trademark 'Ferrori', an intangible property that is unique. As reliable adjustments cannot be made to account for this material product difference, the CUP method may not be the appropriate method in such a case;
- effects of geographical differences: for example, Associated Enterprise 1 sells cars to Associated Enterprise 2 located in South Africa, while an Unrelated Party to which it also sells the same cars is located in Egypt. The only material difference that could be identified between the controlled and uncontrolled transactions concerns the geographical difference. To perform adjustments to account for this difference one should consider, for example, differences in inflation rates between South Africa and Egypt, the competition in the two countries and governmental regulations; and
- major product differences. If reliable adjustments cannot be performed to account for product differences that are material, then the CUP method will not lead to a reliable measure of an arm's length result.

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

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

2.1.3 Strengths and Weaknesses

The strengths of the CUP method include:

- it is not a one-sided analysis as the price is arrived at between two parties to the transaction; and
- avoiding the issue of which of the related parties involved in the controlled transaction should be the tested party for transfer pricing purposes. This issue arises if the other two traditional transaction methods are applied.¹ These methods determine a transfer price based on the perspective of the tested party in the analysis. For example, if the resale price method is used, the related party sales company is the tested party in the transfer pricing analysis. However, if the cost plus method is used, the related party manufacturer will be the tested party. The resulting transfer prices based on these two methods will probably differ from each other; and
- it involves a detailed transactional comparison.

The weaknesses of the CUP method include:

- it will very often be hard to find closely comparable uncontrolled transactions as strict comparability standard is required particularly with respect to product comparability; and
- external CUPs are difficult to find in practice.

2.1.4 When to use the CUP Method?

In cases where comparable uncontrolled transactions can be found, the CUP method is a direct and sound method to determine whether the conditions of commercial and financial relations between associated enterprises are at arm's length. This implies that when examining a transfer pricing issue the analysis should start with the application of the CUP method. That is, one should always consider starting with locating possible internal CUPs and external CUPs. A standard question that should be asked in any analysis is whether one of the associated enterprises involved is engaged in transactions with independent enterprises. In our example of Figure 1 above, the question is whether Associated Enterprise 1 sells comparable cars to an Unrelated Party. Furthermore, does Associated Enterprise 2 purchase comparable cars from an unrelated car manufacturer. If the answer is yes to any one of these questions, then the next step in the analysis is to

¹ Also, if the transactional net margin method is used or the comparable profits method.

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determine the degree of comparability between the controlled and uncontrolled transactions based on the comparability factors. If no internal CUPs can be found, then one should try to locate external CUPs. Data on external CUPs will be hard to find in practice, maybe only when the transactions involve a homogeneous product or service. However, the Guidelines indicate that one should strive to make it possible that the CUP method can be applied possibly in combination with another transfer pricing method.

Based on experience, the CUP method will be most useful in the following situations:

- one of the associated enterprises involved is engaged in comparable uncontrolled transactions with an independent enterprise (i.e. an internal CUP is available). In such a case, all relevant information on the uncontrolled transactions is available and it is therefore probable that all material differences between controlled and uncontrolled transactions will be identified;
- the transactions involve commodity type products in which product differences are negligible; and
- the interest rate charged for an intercompany loan.

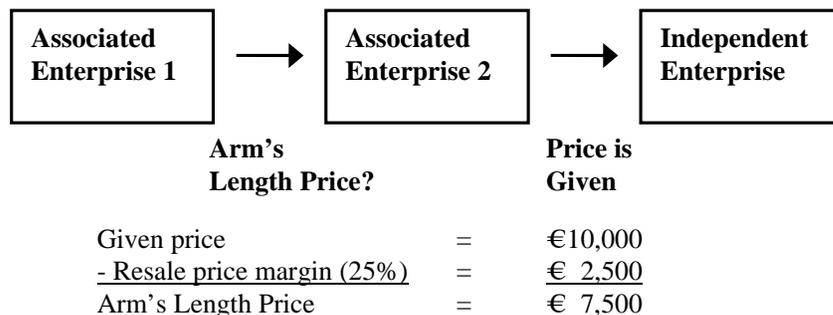
If the CUP method cannot be applied, the next methods available under the Guidelines are two other traditional transactions methods: the resale price method and the cost plus method.

2.1.5 Case Examples *[to be inserted]*

2.2.1 Resale Price Method

The resale price method is one of the traditional transaction methods that can be used to apply 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.

Figure 2: Resale Price Method



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2.2.2 Mechanism of Resale Price Method

The mechanism of the resale price method reduces the price of a product that the related sales company (i.e. Associated Enterprise 2 in Figure 2) charges to an unrelated customer (i.e. the resale price) with an arm's length gross margin, which the sales company uses to cover its selling, general and administrative (SG&A) expenses, and still make an appropriate profit, taking into account the functions performed and risks incurred. The remainder is regarded as an arm's length transfer price for the intercompany transactions between the sales company (i.e. Associated Enterprise 2) and a related company² (i.e. Associated Enterprise 1).

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

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

$$TP = RSP \times (1 - GPM),$$

where:

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

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

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

2.2.3 Arm's Length Gross Profit Margin

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

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

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As discussed above, gross profit equals net sales -/- cost of goods sold of a sales company. The net sales of a sales company concern the sales revenue obtained by selling products to unrelated customers, while the cost of goods sold includes the transfer price paid to the related manufacturer. For a distribution company, cost of goods sold represents the cost of purchasing the goods sold.

Accounting consistency is important in applying the resale price method. Gross profit margins will not be comparable if accounting principles differ between the controlled transaction and the uncontrolled transaction. For example, the comparable distributors may differ from the related sales company in reporting certain costs (e.g., discounts, transportation costs, insurance and costs of performing the warranty function) as operating expenses or as cost of goods sold. Differences in inventory valuation methods will also affect the gross margins. It is thus important that the analysis does not compare “apples with bananas” but rather, “apples with apples”. Therefore, appropriate adjustments should be performed to the data used in computing the gross margin to make sure that ‘similar’ gross margins are compared.

2.2.4 Transactional comparison versus functional comparison

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

- transactional comparison: the gross profit margin that Associated Enterprise 2 earns when reselling cars purchased from an independent manufacturer in comparable uncontrolled transaction. This uncontrolled transaction should initially have been rejected as an internal CUP; and
- 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.

In practice the application of the resale price method is often based on a functional comparison. The benchmarking analysis under functional comparison is performed using publicly available databases.†

Based on the benchmarking and financial analyses, an arm’s length range of gross margins earned by comparable independent distributors is established and fall between x% and y %. If the gross margin earned by Associated Enterprise 2 is within this range, then its transfer price will be considered arm’s length.

† Working Draft Editorial note: As noted above, one possibility would be that taxpayers need not benchmark their transfer pricing with a formal benchmark search in cases where functions and transactions subject to the benchmark do not exceed a stated volume or amount on a fiscal year basis. The industry margins referred to should be: based on objective criteria, regularly updated and readily available at no cost. A possible example could be margins published or formally approved at the appropriate functional level of the UN system, but these do not currently exist.

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2.2.5 Comparability

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

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

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

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

As the gross profit margin remunerates a sales company for performing marketing and selling functions, the resale price method especially depends on comparability regarding functions performed, taking into account assets used and risks assumed. The resale price method thus focuses on functional comparability. A similar level of compensation is expected for performing similar functions across different activities. If there are material differences that affect the gross margins earned in the controlled and the uncontrolled transactions, adjustments should be made to account for such differences. Adjustments should be performed on the gross profit margins of the uncontrolled transactions. The operating expenses in connection with the functions performed and risks incurred should be taken into account in this respect as differences in functions performed are frequently conveyed in operating expenses.

The following factors may be considered in determining whether an uncontrolled transaction is comparable to the controlled transaction for purposes of applying the resale price method:

- The reliability of the resale price method can be influenced by factors that have less effect on price. These factors include cost structures (e.g., the age of plant and

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

- A resale price margin requires particular attention in case the reseller adds substantially to the value of the product (e.g., by assisting considerably in the creation or maintenance of intangible property related to the product (e.g., trademarks or tradenames) and goods are further processed into a more complicated product by the reseller before resale).
- The amount of the resale price margin will be affected by the level of activities performed by the reseller. For example, the distribution services provided by a reseller acting as a sales agent will be less extensive than those provided by a reseller acting as a buy-sell distributor. The buy-sell distributor will obviously obtain a higher compensation than the sales agent.
- If the reseller performs a significant commercial activity besides the resale activity 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.
- In case there is a set of transactions in which goods are distributed through an intermediate company, tax administrations may not only analyse the price of goods that are bought from the intermediate company, but also the price paid by the intermediary company to its own supplier and the functions performed by the intermediate company, if that information is available.
- The comparability analysis should 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 between the controlled and uncontrolled transactions that materially affect the resale price margin.
- 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.

In practice, operating expense adjustments are often performed on the unadjusted gross profit margins of uncontrolled transactions to account for differences in functions performed and the level of activities performed between the related party distributor and the comparable distribution companies. Since these differences are often reflected in variation of the operating expenses, adjustments with respect to differences in the SG&A expenses to sales ratio as a result of differences in functions and level of activities performed may be required.

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2.2.6 Strengths and Weaknesses

The strengths of the resale price method include:

- it is based on the resale price, a market price, and thus represents a demand driven method;
- it can be used without forcing distributors to make unrealistic profits. The distributor should earn an arm's length gross profit margin, however, it can make operating losses due to high selling expenses caused by strategies such as a market penetration strategy;
- the application of the transactional net margin method, which analyses a financial ratio based on operating profits, will generally result in an arm's length range of positive operating profits. The tested party in the analysis should then also earn a positive operating profit within the range. However, the resale price method does not necessarily result in positive operating profits to be earned by the tested party. As a result it can be seen as more realistic.

The weaknesses of the resale price method include:

- it is 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 gross profit margin and hence transfer price, which is based on a benchmarking analysis, can lead to an extreme result (i.e. loss-making) for the related supplier of the sales company; and
- the data on gross margins may not be comparable due to accounting inconsistencies.

2.2.7 When to use the Resale Price Method?

If comparable uncontrolled transactions can be identified, the CUP method is the most direct and sound method to apply the arm's length principle. If the CUP method cannot be applied, however, the next two traditional transaction methods to consider are the cost plus method and the resale price method.

The resale price method is normally used in cases which involve the purchase and resale of tangible property in which the reseller does not add substantial value to the tangible goods by physically modifying the products before resale or in which the reseller contributes substantially to the creation or maintenance of intangible property. The resale price method is thus typically applied to 'marketing operations'.

In a typical intercompany transaction involving a fully-fledged manufacturer owning valuable patents or other intangible properties and affiliated sales companies which purchase and resell the products to unrelated customers, the resale price method is a method to use if the CUP method is not applicable and the sales companies do not own valuable intangible properties.

Consider the example of Figure 2. Assume that Associated Enterprise 1 owns valuable patents to manufacture the cars and a valuable trade name. Associated Enterprise 2 purchases the cars from Associated Enterprise 1 and resells the cars to unrelated dealers in the local country. In such a case, the resale price method will be selected to determine an arm's length transfer price between Associated Enterprise 1 and Associated Enterprise 2 if the CUP method cannot be applied. The cost plus method will not be selected, because the fully-fledged manufacturer (i.e. Associated Enterprise 1)

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owns valuable intangibles, performs R&D activities and generally has operations that are more complex than those of the sales company (i.e. Associated Enterprise 2), the results obtained from applying the cost plus method will not be as reliable as the results obtained from applying the resale price method that uses the sales company as the tested party. It will be very difficult, if not impossible, to identify manufacturers comparable to Associated Enterprise 1 owning comparable intangible properties when applying the cost plus method. The resale price method will establish the transfer price by reference to the resale or gross margins (gross profit/net sales) earned by third party resellers (assuming that internal comparison is not possible) and compares them to the gross margin earned by Associated Enterprise 2 on the cars purchased from related parties.

The resale price method is also typically applied in a commissionaire / commission agent structure involving a principal and related commissionaires / commission agents. In this case, the resale price method will establish an arm's length commission to be earned by the commissionaires / commission agents.

2.2.8 Case Examples

[to be inserted]

2.3.1 Cost Plus Method

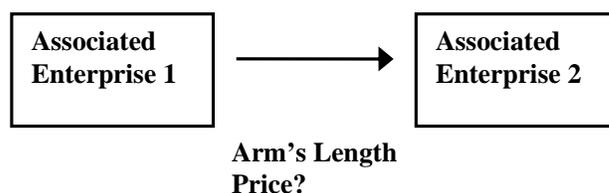
In a controlled transaction involving tangible property, the cost plus method focuses on the related manufacturing company as the tested party in the transfer pricing analysis. The cost plus method may also be used in the case of services rendered.

The cost plus method begins with the costs incurred by the supplier of property (or services) in a controlled transaction for property transferred or services provided to a related purchaser. An appropriate cost plus mark up is then added to this cost, to make an appropriate profit in light of the functions performed and market conditions.

The cost plus method is used to analyse transfer pricing issues involving tangible property or services both under the OECD Guidelines and the US transfer pricing regulations. It is most useful where it is applied to manufacturing or assembling activities. The cost plus method focuses on the related party manufacturer or service provider as the tested party in the transfer pricing analysis. The method evaluates the arm's-length nature of an intercompany charge by reference to the gross profit mark up on costs incurred by suppliers of property (or services) for tangible property transferred (or services provided). It compares the gross profit mark up earned by the tested party for manufacturing the product or for providing the service to the gross profit mark-ups earned by comparable companies.

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Figure 3: Cost Plus Method



Costs for Associated Enterprise 1	=	€5,000
<u>+ Gross Profit Mark Up (50%)</u>	=	<u>€2,500</u>
Arm's Length Price	=	€7,500

Figure 3 explains this further. Associated Enterprise 1, a car manufacturer in country 1, manufactures under contract for Associated Enterprise 2. Associated Enterprise 2 will instruct Associated Enterprise 1 about the quantity and quality of the cars to be manufactured. Associated Enterprise 1 will have guaranteed sales to Associated Enterprise 2 and will face little risk. If the CUP method cannot be applied, then the resale price method and the cost plus method are the next methods to be considered. Because Associated Enterprise 1 is less complex in terms of functions and risks in comparison with Associated Enterprise 2, the analysis would focus on Associated Enterprise 1 as the tested party. Since Associated Enterprise 1 can be regarded as (a simple) manufacturer, the cost plus method is the best method of analysis in subject case. The cost plus method analyses whether the gross profit mark-up earned by Associated Enterprise 1 is arm's length or not. The cost plus method thus does not directly test whether the transfer price is arm's length by comparing prices. As such, it is an *indirect method* compared to the CUP method.

2.3.2 Mechanism of the Cost Plus Method

Under the cost plus method, an arm's-length price equals the controlled party's cost of producing the tangible property plus an appropriate gross profit mark-up, defined as the ratio of gross profit to cost of goods sold (excluding operating expenses) for a comparable uncontrolled transaction.

The formula for the transfer price in intercompany 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 cost of goods sold of the manufacturing company
- 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 sales minus cost of goods sold.

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

2.3.3 Arm's Length Gross Profit Mark-up

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

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

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

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

For example, assume that Associated Enterprise 1, the car manufacturer which manufactures the cars under contract for Associated Enterprise 2, earns a gross profit mark-up of 15 percent on its cost of goods sold and classifies SG&A expenses as operating expenses that are not part of cost of goods sold. Four comparable independent manufacturers are identified which earn gross profit mark-ups between 10 to 15 percent. However, these comparable companies account for SG&A expenses as cost of goods sold. The unadjusted gross profit mark-ups of these comparables are thus not calculated similar to the gross profit mark-up of Associated Enterprise 1. Adjustments should be made on the gross profit mark-ups of the uncontrolled transactions for purposes of accounting consistency.

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2.3.4 Transactional comparison versus functional comparison

The arm's length (range of) gross profit mark-up can be established by 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 CUP; 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.

In practice, the comparability standard of transactional comparison will be much higher than that of functional comparison. 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 the annual reports of comparable companies and the tested party, much less specific information is available with respect to the functions performed and risks incurred by the companies.

However, functional comparison is used most often in practice. The search for comparable companies will be performed using publicly available databases. Based on this benchmarking and financial analyses, an arm's length range of gross profit mark-ups earned by comparable independent manufacturers will be determined (e.g., between 30% and 45%). If the gross profit mark-up earned by the related party manufacturer falls within this range (e.g., 40%), then its transfer price will be considered arm's length.

2.3.5 Comparability

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

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

Similar to the resale price method, close similarity of products between the controlled and uncontrolled transactions is less important under the cost plus method than under the CUP method, while functional comparability (including risks assumed and assets used) is crucial. However, because significant product differences may point out significant functional differences, the controlled and uncontrolled transactions should ideally involve the manufacturing of products within the same product family.

As the gross profit mark-up remunerates a manufacturing company for performing manufacturing function, the cost plus method especially relies on functional comparability (taking into account assets used and risks assumed). If there are material differences that affect the gross profit mark-ups achieved on the controlled and the uncontrolled transactions, adjustments should be made to account for such differences. The adjustments should be made on the gross profit mark-ups of the uncontrolled

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transactions. The operating expenses in connection with the functions performed and risks incurred should be taken into account in this respect as differences in functions performed are frequently conveyed in operating expenses.

2.3.6 Determination of Costs

Next to accounting consistency, the application of the cost plus method entails a number of potential difficulties associated with the determination of the costs:

- costs may not be relevant in determining the profit for a particular year. The link between costs incurred and the market price can be very weak (e.g., a company has incurred few R&D expenses in developing a very valuable technology);
- it is important to apply a comparable mark up to a comparable cost basis. On this point, the following can be noted:
 - differences between the parties being compared, which may influence the mark-up level, should be examined. In this respect, it is crucial to consider differences in the level and types of expenses in connection with the functions performed and risks assumed between the controlled and uncontrolled transactions. If differences represent inefficiencies or efficiencies of the parties being compared, no adjustment to the gross profit mark-up should be made. If differences represent additional functions that are different from the activities being analysed, it may be required to establish a separate remuneration for these additional functions. If differences reflect functional difference, an adjustment to the gross profit mark-up should be made.
 - some costs should be excluded from the cost basis and other costs should include a mark-up. A third category include disbursements incurred in the provision of services, which should simply be reimbursed by the service recipients, and not included in the cost basis on which a mark-up is applied. For example, in the process of rendering marketing services to a related subsidiary, a service provider incurs advertisement expenses paid to an unrelated advertisement agency. These expenses should be reimbursed by the related subsidiary and should not include a mark-up. However, the cost incurred by the service provider in rendering these services should include a mark-up.
 - the cost plus method is typically applied on controlled transactions involving a contract manufacturer which does not own product intangibles and obtains instructions from a related customer about the quantity and quality to produce.

A distinction can be made between a contract manufacturer in which the related customer puts raw materials in consignment with the manufacturer ('consignment manufacturer') and a contract manufacturer which purchases the raw materials itself ('turnkey manufacturer'). The raw materials are used to perform manufacturing functions. The consignment manufacturer does not incur inventory risk relating to the raw materials, while the turnkey manufacturer does take title to the raw materials and therefore incurs this risk. The cost plus method is applicable in both cases if the CUP method cannot be applied. However, the cost basis and the mark-up will be different. The cost

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

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

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

$(RMC/TC) * \text{mark-up on RMC} + (VAC/TC) * \text{mark-up on VAC}$

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

The arm's length mark-up for the consignment manufacturer is equal to the mark-up on value added cost.

In searching for comparable contract manufacturers when applying the cost plus method, it is important to distinguish among the two types of contract manufacturers as discussed above, because of the difference in cost basis and hence the level of the mark-up. The mark-up on total cost of the turnkey manufacturer will generally be lower than the mark-up of a consignment manufacturer, because the cost basis of the turnkey manufacturer include raw material cost, which generally generate a lower mark-up than the value added cost.

For example, assume that Associated Enterprise 1 in Figure 3 is a consignment manufacturer, which means that a related party customer places raw materials on consignment with Associated Enterprise 1. A benchmarking study found three independent turnkey manufacturers which purchase raw materials and incur inventory risks with respect to these raw materials. If this difference materially affect the gross profit mark-up, adjustments should be made on the unadjusted gross profit mark-ups earned by the three comparable companies. However, in case the determination of the gross profit mark-up is based on external comparison, it will be very difficult to distinguish between raw material cost and value added cost from the information on cost of goods sold presented in the annual reports of the potentially comparable companies. As such, the reliability of the analysis will be reduced. Although obtaining this information will be difficult, one should do its best effort as much as possible.

If the determination of the gross profit mark-up is based on internal comparison, however, which means that Associated Enterprise 1 is engaged in comparable transactions with independent enterprises, then much more information is available to perform the adjustments on the gross profit mark-ups earned by Associated Enterprise 1 on the uncontrolled transactions.

- accounting consistency is important. Gross profit mark-ups should be calculated uniformly by the associated enterprise and the independent enterprises.

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- historical costs should in principle be ascribed to individual units of production. If costs differ over a period, average costs over the period may be used.
- One discussion regards whether budgeted cost or actual cost should be used in applying the cost plus method. On the one hand using actual costs will better reflect the few risks faced by the contract manufacturer.³ On the other hand, third parties will usually use budgeted costs in selling products to the market. That is, you will not charge the customer an additional amount at the end of the year if actual costs are higher than budgeted costs. Disbursements on which no mark-up is applied will often be based on actual costs.
- as the costs that may be regarded in using the cost plus method are only those of the manufacturer of the goods or the service provider, a problem may arise with respect to the allocation of some costs between the manufacturer / service provider and the purchaser of goods/services.
- in case the transactions involve the removal of marginal production, it may be possible to use variable costs or marginal costs.

2.3.7 Strengths and Weaknesses

The strengths of the cost plus method include:

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

The weaknesses of the cost plus method include:

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

2.3.8 When to Use to Cost Plus Method?

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

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

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than the contract manufacturer in terms of functions performed (e.g., conducting marketing and selling functions, coordination of production and sales, giving instructions to contract manufacturer about the quantity and quality of production, and purchasing raw materials in some cases), risks incurred (e.g., market risk, credit risk and inventory risk) and assets owned (product intangibles). The contract manufacturer is thus the less complex and as such should be the tested party in the transfer pricing analysis.

The cost plus method is usually not a suitable method to use in transactions involving a fully-fledged manufacturer which owns valuable product intangibles as it will be very difficult to locate independent manufacturers owning comparable product intangibles. That is, it will be hard to establish a profit mark-up that is required to remunerate the fully-fledged manufacturer for owning the product intangibles. In a typical transaction structure involving a fully-fledged manufacturer and related sales companies (e.g., commissionaires), the sales companies will normally be the least complex entities involved in the controlled transactions and will therefore be the tested party in the analysis. The resale price method is applied in such cases.

Next to simple manufacturing activities, the cost plus method can also be used in the following cases:

- the intra-group provision of services (e.g., legal, accounting, information technology, marketing, tax, and management services) if the services can be considered to provide a benefit to the service recipient.
- the provision of contract research services by Associated Enterprise 1 to Associated Enterprise 2. Associated Enterprise 2 incurs the risks that the research activities do not lead to any results. However, it will own the intangible properties developed under the research services rendered by Associated Enterprise 1
- the administration of licenses (i.e. the administration and enforcement of intangible property rights as opposed to the exploitation of these rights)