Transfer Pricing Profit Split Methods

A Practical Solution?

Master’s Thesis within the International Master Program of Commercial and Tax Law

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Abstract

The purpose of this master’s thesis is to explain and analyze whether today’s existing regulations provide sufficient guidance on how to apply the Profit Split Method (PSM) in practice. Since the enterprises’ profits arising from intra-group transactions increases, the tax base for any government also becomes larger and more important. This issue will likely become even more problematic as the globalization branches out and the majority of the global trade is undertaken between associated enterprises.

In order to satisfy all parts and serve the dual objective of securing an appropriate tax base in each jurisdiction and avoiding double taxation, one ambition of the OECD is to harmonize the transfer pricing rules and make them become more uniform. An area in which this goal can be accomplish is at an international level such as the OECD; an important developer in the field of transfer pricing. Different transfer pricing methods has been developed which can be applied by both taxpayers and tax authorities to determine a correct transfer price. Six of these methods has gained international acceptance, although to a more or less extent among various countries, and one of these methods is the PSM. In the years between 1979 and 1995, the OECD had a reluctant standpoint of accepting the application of any transfer pricing method based on profits, such as the PSM. This hesitant viewpoint changed in the existing TPG which explicitly stipulates that the PSM could provide a transfer pricing estimation in accordance with the ALP, which should be accepted in exceptional cases.

There are certain situations where a PSM possibly will provide the most appropriate arm’s length result. Since the principle of economics can create complex business environments of both vertical and horizontal integration, contributions of valuable intangibles on both sides of the cross-border transaction, the PSM might be the only method which can be employed. A relevant issue which need to be enlightened is whether the existing guidance provided by the OECD and USA is sufficient from a practitioners and tax administration point of view, or is more guidance needed to better understand the issues surrounding the concept of the PSM. The fact that OECD insist of using comparables to the highest extent as possible when employing the PSM entails practical problems, since it is rather a rule than an exception that reliable comparables cannot be found when valuable intangibles are involved.

The Arthur of this master’s thesis has identified three key conclusions which might facilitate how PSM issues can be handled in the future and improve the existing PSM guidance. These conclusions are the need for a uniform PSM interpretation, the need for additional flexibility and acceptance, and the need for additional TPG guidance.
Acknowledgements

I would like to dedicate my respect and thankfulness to my tutor Professor Hubert Hammakers for his guidance in the process of writing this master’s thesis.

I would also like to express my deepest gratitude to my mentor Maria Planthin at the PwC Transfer Pricing department in Stockholm, for all her help and positive source of inspiration.

Yours Gratefully,

Yousef Quttineh
**Abbreviations**

<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Description</th>
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<tr>
<td>AE</td>
<td>Associated Enterprise</td>
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<tr>
<td>ALP</td>
<td>Arm’s Length Principle</td>
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<tr>
<td>CFA</td>
<td>Committee on Fiscal Affairs (OECD)</td>
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<td>CPM</td>
<td>Comparable Profits Method</td>
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<tr>
<td>CUP</td>
<td>Comparable Uncontrolled Price</td>
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<td>CUT</td>
<td>Comparable Uncontrolled Transaction</td>
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<tr>
<td>C+</td>
<td>Cost Plus Method</td>
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<tr>
<td>EBIT</td>
<td>Earnings Before Interest and Taxes</td>
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<td><em>i.e.</em></td>
<td><em>id est</em> (that is to say)</td>
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<tr>
<td><em>e.g.</em></td>
<td><em>exempli gratia</em></td>
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<td>Ibid</td>
<td><em>ibidem</em> (in the same source)</td>
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<tr>
<td>IFA</td>
<td>International Fiscal Association</td>
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<tr>
<td>IRC</td>
<td>Internal Revenue Code</td>
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<td>IRS</td>
<td>Internal Revenue Service</td>
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<td>MNE</td>
<td>Multinational Enterprise</td>
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<td>MTC</td>
<td>OECD Model Tax Convention</td>
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<td>OECD</td>
<td>Organization for Economic Co-operation and Development</td>
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<td>PSM</td>
<td>Profit Split Method</td>
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<td>RPM</td>
<td>Resale Price Method</td>
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<td>R&amp;D</td>
<td>Research and Development</td>
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<td>TNMM</td>
<td>Transactional Net Margin Method</td>
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<td>TPG</td>
<td>OECD Transfer Pricing Guidelines</td>
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<td>TPM</td>
<td>Transfer Pricing Method</td>
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<td>USA</td>
<td>United States of America</td>
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I Introduction

1.1 Background

Transfer pricing is not an exact science\(^1\). The wording “transfer pricing” basically refers to cross-border business transactions between associated enterprises.\(^2\) Over the last 20 years, cross-border transactions have increased rapidly.\(^3\) Nowadays, about 60-70% of these cross-border transactions, i.e. around two out of three, are undertaken between associated enterprises\(^4\) (AE) which belongs to the same group of companies.\(^5\)

Since the enterprises’ profits arising from intra-group transactions increases, the tax base for any government also becomes larger and more important.\(^6\) Many countries levy tax on each and every company instead of taxing the group of companies as a whole. A tax base may thus decrease, for instance in a country with a high corporate tax, if the transfer pricing is being manipulated.\(^7\) Therefore, legal transfer pricing issues for tax purposes arises when countries protect their tax bases and tax authorities performs audits in order to find out whether the transfer prices are correct set. This issue will likely become even more problematic as the globalization branches out and the majority of the global trade is undertaken between multinational enterprises (MNE)\(^8\).

An important body in the legal area of transfer pricing is the Organisation for Economic Co-Operation and Development (OECD), an international organization established in 1961. The OECD consists of 30 Member Countries, has its headquarter in Paris and a secretariat staff of 2500 peoples.\(^9\) Although the United States of America (USA) is one of the OECD Member Countries, prima facie, it might occur peculiar that domestic USA transfer pricing regulations has a great impact on the development of the world-wide transfer pricing standards.\(^10\) For instance, regarding the different transfer pricing methods which are applied by taxpayers and tax authorities in order to assess “correct” transfer prices on transac-

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\(^1\) OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, Paris 1995 (Hereinafter TPG.), Paras. 1.12 and 4.8. (also 1.45.)


\(^3\) TPG, Preface, Para. 1.

\(^4\) Associated Enterprises can be defined as “Two enterprises are associated enterprises with respect to each other if one of the enterprises meets the conditions of Article 9, sub-paragraphs 1a) or 1b) of the OECD Model Tax Convention with respect to the other enterprise”, TPG, Glossary.


\(^7\) Ibid.

\(^8\) Multinational Enterprise can be defined as “A company that is a part of an MNE group.”, TPG, Glossary.

\(^9\) Facts taken from the The Official OECD homepage.

\(^10\) Amerkhail, Valerie, *Functional Analyses and Choosing the Best Method*, Chapter 12, p. 12-3. (§ 12.01[1]).
tions between associated enterprises, i.e. “controlled transactions”. Over the last 30 years, the USA transfer pricing approach has actually been designed with a presumption that foreign MNE located in the USA use transfer pricing regulation to withhold taxable profits. Hence, the USA is also considered as an important developer in the field of transfer pricing.

Thirty years ago, an organ within the OECD, the Committee of Fiscal Affairs (CFA), encouraged its Member Countries to implement the “Arm’s Length Principle” (ALP) in order to harmonize and prevent disputes between taxpayers and tax authorities interpretations of a correct transfer price. The implementation and purpose of the ALP is to provide a solution for establishing correct transfer prices and thus the right amount of taxable profit for each enterprise. This means that each enterprise should be regarded as a separate entity, for instance on the subject of tax matters, regardless if it belongs to a corporate group; “[O]ecd member countries have chosen this separate entity approach as the most reasonable means for achieving equitable results and minimizing the risk of unrelieved double taxation. Thus, each individual group member is subject to tax on the income arising to it (on a residence or source basis).”

In order to satisfy all parts and serve the dual objective of securing an appropriate tax base in each jurisdiction and avoiding double taxation, one ambition of the OECD is to harmonize the transfer pricing rules and make them become more uniform. An area in which this goal can be accomplish is at an international level such as the OECD; an important developer in the field of transfer pricing. Different transfer pricing methods has been developed which can be applied by both taxpayers and tax authorities to determine a correct transfer price. Six of these methods has gained international acceptance, although to a more or less extent among various countries, and one of these methods is the Profit Split Method (PSM). There are certain situations where a PSM possibly will provide the most appropriate arm’s length result. Since the principle of economics can create complex business environments of both vertical and horizontal integration, contributions of valuable intangibles on both sides of the cross-border transaction, the PSM might be the only method which can be employed. These business environments might be unique of its kind and consists of contributions which only exist within a group of companies. Thus, it might be

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11 Controlled Transactions can be defined as “Transactions between two enterprises that are associated enterprises with respect to each other”, TPG, Glossary.


13 Amerkhail, Valerie (2006), Functional Analyses and Choosing the Best Method, Chapter 12, p. 12-3. (§ 12.01[1]).


16 TPG, Preface, Para. 5.

17 TPG, Para. 7.


impossible to find comparable information from independent enterprises which can be utilized in any other method than the PSM.\footnote{OECD, \textit{Discussion Draft on the Transfer Pricing Aspects of Business Restructurings}, 19 September 2008 – 19 February, [page. 47.], Para 165.} A relevant issue which need to be enlightened is whether the existing guidance provided by the OECD and USA is sufficient from a practitioners and tax administration point of view, or if more guidance needed to better understand the issues surrounding the concept of the PSM.

\subsection*{1.2 Purpose and Approach}

The purpose of this master’s thesis is to explain and analyze whether today’s existing regulations provide sufficient guidance in how to apply the PSM in practice.

We will also try to draw some general conclusions of certain transfer pricing situation where the different PSM approaches are most appropriate to employ in practice, \textit{i.e.} which of them gives the most fair result in accordance with the guidance set out in OECD regulations, but also USA to some extent. Moreover, practical issues which may arise when the profits shall be determined and allocated will also be presented. Finally, the thesis will examine whether the PSM might come in conflict with other methods or not, such as Transactional Net Margin Method (TNMM) for instance.

\subsection*{1.3 Method}

A combination of two methods has been chosen and used in this thesis in order to fulfill the purpose; the traditional legal method and basics of the comparable method. A traditional legal method is a study of the “source of law” hierarchy to be used in a legal situation and this method will be considered when the USA regulation is being examined.\footnote{Zweigert, Konrad., Kötz, Hein., \textit{Introduction to comparative law}, pp. 35-36.}

The main aim of comparative law is to gain knowledge as with any other science.\footnote{Ibid, p. 15.} A comparative method examines different legal systems of the world and compares them with each other.\footnote{Ibid. p. 2.} In order to fulfill the purpose of this thesis, a comparison between the relevant transfer pricing regulations of both the OECD and the USA will be made. Since the OECD regulations constitute “soft law”\footnote{Please see TPG, Preface, Para. 16. “Members are encouraged to follow these guidelines(…)”}. this master’s thesis does not perform a refined comparative study of two different law system, but rather two main characters in the transfer pricing development field. Hence, a conclusion will be drawn regarding which regulations provides the best result, if any, or if further guidance is required.\footnote{Zweigert, Konrad., Kötz, Hein., \textit{Introduction to comparative law}, p. 6.}

Moreover, a comparative study can be made in a bigger or a smaller scale, \textit{i.e.} “macrocomparison” and “microcomparison”.\footnote{Ibid, pp. 4-5.} This thesis will compare the OECD and the USA transfer pricing regulations regarding the PSM with a microcomparison approach, by putting
emphasis on whether the different regulations gives enough guidance in how to apply this method and its different approaches in practice.

### 1.4 Delimitations

This master’s thesis will only discuss transfer pricing from the general perspective of cross-border transactions which should comply with the ALP. The focus will first and foremost be on the PSM but also other can be employed to assess arm’s length transfer prices. Thus, this master’s thesis only emphasis on the PSM and not on transfer pricing problems that might occur when other transfer pricing methods (TPM) are employed. Moreover, transfer pricing as a business term in only discussed in brief. Furthermore, the automobile industry will be mentioned but other relevant industries such as the pharmaceutical and finance industry provide typical PSM situations as well. Losses will also be excluded but split of losses is regulated under the same principles as the split of profit. Adjustments in any cases are also regarded. Only brief description of intangible property and searches for reliable comparables will be presented, since both these matters are practical issues. The used of hindsight is excluded in this master’s thesis as well.

### 1.5 Outline

The purpose of Chapter 1 is to give some basic information about transfer pricing and describe some issues which are connected to this field of international taxation. The aim is to call upon the reader’s interest and to direct the reader to the purpose of this master thesis. Chapter 2 will read up on the history/basics of transfer pricing such as the ALP and a description of the two main leading characters of transfer pricing development; the OECD and the USA. (Swedish Transfer Pricing Legislation will also be enlightened very briefly). The purpose of this chapter is to present a basic understanding of the relation of possible double taxation issues which may occur, if transfer prices are not determined according to the ALP. The aim of chapter 3 is to clarify the importance of different transfer analyses which must be undertaken, i.e. a broad base, functional and comparability analyses. These analyses compose a foundation which enables an application of any of the internationally accepted transfer pricing methods, which are used to assess transfer prices according to the ALP. Chapter 4 describes the internationally accepted transfer pricing methods and compares them briefly with the USA regulations concerning transfer pricing methods. The reason why all these methods are being described, however briefly, is because that any of these methods may be employed under the application of the PSM residual approach. The purpose of Chapter 5 and 6 is to assemble all relevant facts and guidance which can be found regarding the PSM from OECD supplemented by relevant articles. Three different PSM approach will be explained in detail and some examples of when a PSM may be most appropriate to apply. Chapter 7 is an analysis which aims to connect all the relevant information which was been provided about the different PSM approaches in chapter 5, in the light of all the previous chapters. The analysis will provide some practical solutions on how this total profit can be properly divided among the involved enterprises under the different allocation approaches. Chapter 8 will read up some comments and recommendations which can be considered in order to facilitate transfer pricing in the future.

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2 Transfer Pricing Overviews

2.1 Introduction

From a legal point of view, transfer pricing legislation is limited to transactions at “corporate level” and the rules do not apply on transactions at the “shareholder dividend level”.28 An explanation for the origin of transfer pricing regulations may be that every country is eager to credit a fair share of the corporate tax on profits made by companies operating within the county.29 This may also be an explanation to why transfer pricing fuel concerns over both taxpayers and tax administrations.30 Countries’ domestic legal frameworks are diverse and the different tax jurisdictions have their own interpretations of transfer pricing, in excess of different corporate tax rates.31 The enlargement of MNEs generates an increased amount of complex tax issues for both taxpayers and the tax authorities in different countries.32 Especially in practice, when the activities within a multinational enterprise group (MNE group33) tend to be highly integrated.34 Vertical integration can be defined as “[t]he process in which several steps in the production and/or distribution of a product or a service are controlled by a single company or entity, in order to increase that company’s or entity’s power in the market place”.35 Today, networks within many MNE group36 are integrated such as the automobile industry as an example.37 Transfer prices are generally set by reference to market forces and tax authorities should therefore not presume that transfer prices are being manipulated.38 From an economical viewpoint, transfer pricing is a result of a business reasons in line with the sound economic basic principle of generating a reasonable surplus.39 One way of being more profitable can be to increase the business efficiency by reorganizing the structure in the group of compa-

28 For instance, please see Arm’s Length Principle laid down in Article 9(1) of the OECD Model Tax Convention on Income and on Capital which only refers to enterprises of being subject to an adjustment. See also USA Transfer Pricing Regulations (1994), Treas. Reg. Sec. § 1.482-1(b)(1) which stipulate “[I]n determining the true taxable income of a controlled taxpayer, the standard to be applied in every case is that of a taxpayer dealing at arm’s length with an uncontrolled taxpayer.” (emphasis added).
29 TPG, Preface, Para. 12.
30 Miller, Angharad., Oats, Lynne, Principles of International Taxation, p. 244.
31 Boos, Monica,. International Transfer Pricing: The Valuation of Intangible Asset, p. 2.
32 TPG, Preface, Para. 1. See also TPG, Paras. 1.8 and 1.9.
33 Multinational Enterprise group can be defined as “A group of associated companies with business establishments in two or more countries.”, TPG, Glossary.
34 TPG, Preface, Para. 2.
35 Source can be found at the Homepage of Investorwords. (http://www.investorwords.com/5977/vertical_integration.html).
36 TPG, Glossary.
37 Pearson, Thomas C, Proposed International Legal Reforms for Reducing Transfer Pricing Manipulation of Intellectual Property, page 550 (Information can be found in footnote 32).
38 TPG, Para. 1.2.
nies, for example to by allocating the functions in the group as to become more internationally vertically integrated. For instance, if the MNE group cannot supply a market in another country through export an option is to expand the production and/or distribution. Moreover, it might be necessary to lower the future transfer in order to penetrate the market. Another reason can of course be due to tax planning but it would be incorrect to say that this is always the case. Tax planning it is just one among a number of economically reasons to consider for a MNE group.

2.2 Arm’s Length Principle

2.2.1 The OECD

The ALP is based on the separate entity approach. Although the ALP has two different origins which both were based on the concept of equal treatment or the neutrality principle, it was explicitly introduced for the first time in a multilateral context from 1933. For tax purposes, prices on controlled transactions should be set as unrelated companies in an open market would have set their prices on similar transactions and under similar conditions (i.e. uncontrolled transactions). Nowadays, this “dealing at arm’s length” principle is an internationally accepted standard for the allocation of taxable profits between AE.

The OECD defines the ALP as “[t]he international standard that OECD member countries have agreed should be used for determining transfer prices for tax purposes. It is set forth in Article 9 of the OECD Model Tax Convention (...)”. Hence, if a MNE’s taxable income would be greater due to incorrect pricing on controlled transactions; the profits


42 TPG, Para. 1.4.

43 IBFD online database, under the heading “General” and the sub-heading “Introduction to Transfer Pricing”, “Transfer Pricing from a Business Economics Perspective”, written by Prof. Dr Hamaekers.

44 TPG, Paras. 5 and 6.


47 Uncontrolled Transactions can be defined as “Transactions between enterprises that are independent enterprises with respect to each other”, TPG, Glossary.


49 TPG, Para. 1.1. See also OECD Commentary on the OECD Tax Convention on Income and Capital, “Art. OECD Commentary on article 9 concerning the taxation of associated enterprises”, Para. 1.

50 TPG, Glossary.
may be adjusted by the tax authorities in that country, to the extent as if the prices were within an arm’s length range.  

The definition of whether companies are “related” or “associated” is still a question of interpretation under domestic law, which may differ from country to country.  The ALP only applies to AE. It is therefore necessary to analyze the definition of an AE under domestic law and examine whether it is comprehensible in the contexts of relevant tax treaties and OECD regulations. Beyond the basic fact that at least two persons or companies must be located in different countries, the OECD put emphasis on three different prerequisites to be regarded as AE; management, control or capital. These prerequisites are independent from each other, i.e. the persons or companies are considered associated if at least one of the prerequisites is fulfilled. The OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (TPG) do not read up on detailed information of the term “associated enterprise”. Thus, a tax authority in one country might characterize a cross-border transaction that is undertaken by two AE to be a controlled transaction, while the other OECD country might characterize the same cross-border as an uncontrolled transaction. 

2.2.2 The USA

The USA government agency, Internal Revenue Service (IRS), is responsible for tax collection and tax law enforcement. The USA Federal tax law is enacted by the congress and begins with the Internal Revenue Code (IRC), which contains a great number of sections. Every section must be considered in the context of the entire IRC and with court interpretation taken into account. Section 482 enables IRS to legally make transfer pricing adjustment on set transfer prices outside an arm’s length. The USA Regulations states that “[t]he arm’s length result of a controlled transaction must be determined under the method that, under the facts and circumstances, provides the most reliable measure of an arm’s length result.”

The purposes of the USA transfer pricing regulations are tax equality between controlled and uncontrolled taxpayers. The basic transfer pricing prerequisites in the USA tax legisla-

51 OECD Model Tax Convention on Income and on Capital, Article 9(1).
53 OECD Commentary on the OECD Tax Convention on Income and Capital, “Art. OECD Commentary on article 9 concerning the taxation of associated enterprises”, Para. 1.-]. See also TPG, Para. 2.3.
54 OECD Model Tax Convention on Income and on Capital, Article 9(1).
55 Id.
56 OECD, Comparability, [page. 33.], Para. 22.
57 Facts taken from the official website of the IRS, (http://www.irs.gov/taxpros/article/0,,id=98137,00.html#irc).
tion are similar to the OECD but put more emphasis on “control”. It applies to parties with shared interests, i.e. “two or more organizations, trade or business, whether or not incorporated (whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests (…)”. The USA definition of the word “controlled” is widely interpreted and it is the real actual control that is decisive and not the form or the mode of its exercise. The meaning of a controlled taxpayer includes one taxpayer which owns or control one or more other taxpayers. The owned taxpayer(s) are controlled if they directly or indirectly share the same interests as its owner. Thus, a controlled taxpayer always requires another taxpayer at the other end which is either owned by the controlled taxpayer or vice versa.

2.2.3 Swedish Legislation

The Swedish basic transfer pricing interpretation of AE is when the two parties share the same community of interests. The ALP can also be found in Swedish legislation as “Korrigeringstavgivning”. This rule stipulates that all international transactions between enterprises sharing the same interests shall be taxed as is an arm’s length price remunerations has been charged, i.e. the Swedish company’s taxable income is subject to being adjusted to reflect a level as if the companies would not have been associated. In order for the taxpayers and tax authorities to find further guidance in transfer pricing, the Swedish Supreme Court has stated that the OECD Guidelines shall serve as supervision. By that ruling, the status of the TPG was recognized to ascend as a source of law.

2.3 Primary and Corresponding Adjustments

According to Article 9 of the MTC, taxable profit may be subject of being adjusted upwards in one country by the tax authorities as to increase, i.e. “primary adjustment”. An adjustment downwards is less likely since tax authorities unlikely be an initiator to lessen the taxable profits of a related enterprise. When a tax authority adjusts taxable profits due to incorrect transfer pricing, at least one of the standard transfer pricing methods are applied to demonstrate what the correct pricing should have been. It may be the case that the tax administration considers that the currently employed method is misapplied or that another method with a higher rank or that a PSM would have provided a more reliable transfer price according to the ALP.

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65 RÅ 1991 ref. 107.
66 TPG, Glossary. Please also see TPG, Para. 4.32.
67 TPG, Paras. 1.36. and 4.9.
Transfer prices which fall outside an arm’s length range should be adjusted to correspond to the points within the range that reflect a correct transfer price as good as possible, according to the OECD. The USA approach is different since their policy is more standardized and incorrect transfer prices are adjusted to correspond to a “true taxable result”, i.e. an arm’s length range. Prima facie, one might suppose that the USA approach is consistent as it also works the other way around. If transfer prices on controlled transactions fall within the arm’s length range, no adjustment will be made by the IRS regardless if another point within the range reflects the facts and circumstances better. However, the IRS can challenge the underlying benchmark study which has been made to assess the transfer prices which fall within the arm’s length range.

If taxable profit is adjusted upwards as to increase the taxable profits in one country, must the taxable profits of the AE in the other country must be adjusted downwards (as to decrease the taxable profits), in order for the total taxable profits to be counter-balanced. This latter counter adjustment is known as a “corresponding adjustment” or “secondary adjustment”. An important difference between a primary- and corresponding adjustment is that the latter is overlooked in Article 9 of the MTC since is regarded to be a domestic tax issue rather than an international. Hence, a taxpayer should bear in mind that a compensating adjustment is not a given procedure. Tax authorities tend to be rigid to undertake corresponding adjustments since all countries are very keen to protect its tax base. The absence of a corresponding adjustment will likely trigger a dilemma since double taxation might occur, which is one of the goals for the OECD to prevent. A way for tax administrations in two different OECD Member Countries to solve double taxation disputes which arises from primary adjustment, can be made by means of a mutual agreement procedure under Article 25 of the MTC.

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69 TPG, Paras. 4.121-4.123.
70 USA Transfer Pricing Regulations (1994), Treas. Reg. Sec. § 1.482-1(a)(2) and § 1.482-1(b)(1).
73 TPG, Glossary. Please also see TPG, Para. 4.38.
74 OECD Commentary on the OECD Tax Convention on Income and Capital, “Art. OECD Commentary on article 9 concerning the taxation of associated enterprises”, Para. 8.[5].
75 Ib, Para. 6.[3].
76 TPG, Para. 4.39.
77 TPG, Para. 4.2.
78 TPG, Paras. 4.29-4.31. Also, Para. 4.30 refer to Paragraph 9 of the Commentary on Article 25 which can be found in the OECD Commentary on the OECD Tax Convention on Income and Capital.
3 Transfer Pricing Analyses

3.1 Introduction

Different transfer pricing policies are suitable depending on the structure and character of the undertaken controlled transactions.\(^{77}\) It is desirable to survey and map out the facts and circumstances of the specific transfer pricing situation before or in connection with the time for when the transfer prices are set.\(^{80}\) This way can useful information be obtained in order to document a sustainable transfer pricing policy which can pass an audit and be approved by a tax administration.\(^{81}\)

In practice, this procedure is generally preferred to start with a broad based analysis, followed up by a functional analysis and a comparability analysis.\(^{82}\) However, these different analyses are just tools/formal terms for facilitate the understanding of the specific transfer pricing situation and can sometimes be hard to separate from each other.\(^{83}\) For both taxpayers and tax authorities, the main goal is to assure whether a first-time established or an already existing transfer pricing policy can be justified under the arm’s length principle or not.\(^{84}\) The establishing and documentation of a transfer pricing policy is an on-going process and not a solitarily occasion.\(^{85}\) If a company group already has a transfer pricing policy, consideration should still be taken by the taxpayers regarding adequate record keeping, to make sure that the transfer pricing policy is up to date and comply with relevant transfer pricing regulations.\(^{86}\)

3.2 Broad-Base Analysis

A number of relevant questions will now be described and facilitates the search for useful information if they can be answered.\(^{87}\) Firstly, it is important to disentangle the legal structure for all of the companies belonging to the company group and to locate in which countries they carry on business.\(^{88}\) Furthermore, a broad-base analysis is a wider survey which examines the actual business sector(s) the company group operates in.\(^{89}\) Certain markets are

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\(^{77}\) For instance, please see TPG, Paras. 1.12 and 1.36. See also OECD, *Comparability: Public Invitation to Comment on a Series of Draft Issues Notes*, 10 May 2006, [page. 23.], Para. 3.

\(^{80}\) TPG, Para. 5.16. See also Paras. 5.3-5.15.

\(^{81}\) TPG, Para. 1.36 and 1.45-1.47.

\(^{82}\) OECD, *Comparability*, [page. 45.], Para. 1.

\(^{83}\) OECD, *Comparability*, [page. 46.], Para. 2-3.

\(^{84}\) TPG, Para. 5.2.

\(^{85}\) TPG, Para. 5.14.

\(^{86}\) Ibid. and TPG, Para. 1.20.

\(^{87}\) OECD, *Comparability*, [page. 6-7.], Para. 14.

\(^{89}\) Ibid. and TPG, Para. 1.20.
more complex than others e.g. the automobile industry\(^{90}\) tends to be very integrated and/or involve intangible property.

Henceforth should the associated relations between the companies be made clear, for example if the involved enterprises operate on a short contract term or long contract term basis.\(^{91}\) The relationships between the companies within the group are fundamental factors to determine if an independent company would have carried on business in the same way. It gives an indication and guidance of whether conditions in controlled transactions are at arm’s length or not and to which extent independent enterprises can be comparable.\(^{92}\) The risk management of the company group play an important role as they have control over the overall decision making process, e.g. questions in matters regarding the company strategy, power to reallocate functions in the company group, decide about acquisitions and mergers, etc.\(^{93}\) It is therefore essential to ascertain which people who has the actual power to make such decision and to locate where they are physically located.\(^{94}\)

### 3.3 Functional Analysis

#### 3.3.1 The OECD

The OECD stipulates that a functional analysis “[s]eeks to identify and to compare the economically significant activities and responsibilities undertaken or to be undertaken by the independent and associated enterprises.”\(^{95}\) Moreover, “[t]he functional analysis not only informs the choice between traditional transaction methods and transactional profit methods; it also informs the choice among traditional methods (for instance the cost plus and resale price methods have the same ranking in the TPG but are applied to different outcomes of functional analyses) and among transactional profit methods.”\(^{96}\)

#### 3.3.2 Relevant Factors to Examine

A fundamental procedure is to identify all the undertaken controlled transactions between enterprises within the company group.\(^{97}\) For instance due to the fact that the identified controlled (or uncontrolled) transactions comprises a large number of similar or identical nature\(^{98}\) or if the controlled transactions cannot easily be separated from each other\(^{99}\), which

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\(^{90}\) OECD, *Comparability*, [page. 30.], Paras. 2-3.

\(^{91}\) TPG, Paras. 1.5. and 1.28-1.29.

\(^{92}\) Ibid.


\(^{95}\) TPG, Para. 1.30.


\(^{99}\) TPG, Para. 1.42.
for instance can be the case when the company group structure is highly integrated. Depending on the facts and circumstances of the case, the taxpayer may instead “aggregate” the identified controlled (or uncontrolled) transactions when that is more appropriate, given that the reasons for such an aggregation is explicitly documented.\textsuperscript{100}

As the broad-base analysis can be seen as a tool to grasp an overview of the whole picture of the company structure, the functional analysis can be seen as a more detailed analysis of the undertaken contributions which are carried out among the companies in this picture. Thus, the taxpayer must straighten out which types of activities that actually exists and secondly investigate which of the companies that really performs the identified activity.\textsuperscript{101} This step can sometimes be hard as the more integrated the company group structure is, the harder it can be to disentangle the undertaken contributions and identify the actual performer. For instance, the transactions may be very interrelated and cannot be evaluated on a separate basis, but performed contributions can indeed be economically valued with reliable information by applying a PSM.\textsuperscript{102} It is the contributions that creates a real value which are the most important to identify in order to enable a correct valuation of the performed contributions, especially regarding intangible property.\textsuperscript{103} Transactions could in general be categorized in three different terms such as tangible property, services and intangible property.\textsuperscript{104} A typical performed tangible property activity can for example be to manufacture goods; a common service may be to carry out marketing and advertising activities for the entire company group; an example of an intangible function can be research and development (R&D).\textsuperscript{105}

Another factor to consider is to which extent risk is undertaken.\textsuperscript{106} A typical economical risk measurement formula is “Rate of Return”.\textsuperscript{107} For instance, a relevant risk can regard a contract manufacturer which barely takes any risk since the entire product order is made in advance by a MNE. Conditions about relevant risks can be found in written contractual terms between the MNE and a risk should be actual and proportional, to collaborate with the ALP.\textsuperscript{108} For instance an investment risks in R&D which outcome is uncertain to be of success or failure.\textsuperscript{109}

\begin{thebibliography}{100}
\bibitem{100} Id. and OECD, \textit{Comparability}, [page. 68.], Para. 23.
\bibitem{102} TPG, Para. 3.5.
\bibitem{104} For instance, please see the TPG, Para. 1.19.
\bibitem{105} For instance, please see TPG, Para. 1.21.
\bibitem{106} For instance, please see TPG, Para. 1.23.
\bibitem{107} PricewaterhouseCoopers, \textit{International Transfer Pricing} 2009, p. 45.
\bibitem{108} see OECD, \textit{Transactional Profit Methods: Discussion Draft for Public Comment}, January 2008, [page. 29.], Para. 60. With reference to TPG, Paras. 1.27-1.29.
\bibitem{109} For instance, please see the TPG, Para. 1.24.
\end{thebibliography}
A third factor is to examine the different types of assets which are used in the controlled transactions and to define, if possible, “which MNE is doing what” i.e. makes the contribution. This can especially be hard to determine if the controlled transaction involve valuable intangible assets. Moreover, if two or more valuable intangible assets are contributed by more than one associated company, it gets even more difficult to actually distinguish the two different valuable intangible used assets which are being used in the controlled transaction. Hence, reliable information to be used in a transfer pricing method in order to establish an arm’s length transfer price might be impossible to find, for instance due to high level of integrity in the MNE group. Under such circumstances can PSM provide a solution. Although the application of PSM may sometimes contain some practical issues which will be discussed in Chapter 6.

The fourth and most important factor to identify in the functional analysis is so called “value drivers”, in order to employ a PSM in a reliable manner. A value driver is a function, risk or used asset (or a combination of them) that contribute to generate profit, as it imposes value to the controlled transaction in larger compass. Value drivers are often associated with entrepreneurial characteristics which for instance can be unique performed functions or used intangible assets and high risk taking. Value drivers are usually connected with contributions which can be found in “Entrepreneurial function”. A well established functional analysis should reflect where the value is created, i.e. consist of a “value-chain analysis” and identify which risk is taken by which MNE. A “routine-function” on the other hand is a function, risk or asset (or combinations of them) which imposes a low-value creating effect on the controlled transaction and could thus be considered as the opposite of an entrepreneurial function.

Regarding the comparability analysis (which will be described below), routine functions are also known as “benchmarkable functions” since “[b]enchmarkable functions, assets and risks are functions, assets and risks for which reasonably reliable comparables exist” and this

110 Gonnet, Sébastien., Fris, Pim., “Contribution analysis under the profit split method”, p. 9. Also, the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, Para. 1.22.
111 TPG, Para. 6.6.
112 TPG, Para. 6.26.
114 TPG, Para. 6.26.
115 For instance, please see OECD, Discussion Draft on the Transfer Pricing Aspects of Business Restructurings, 19 September 2008 – 19 February, [page. 58.], Para 217.
119 OECD, Transactional Profit Methods: Discussion Draft for Public Comment, January 2008, [page. 70.], Para. 239. (In Footnote 27 refers to routine-functions).
definition will likely be added in the Guidelines issued in future.\textsuperscript{120} Contradictory, if reasonably reliable comparables cannot be obtained, such a function considered to be an “unique contribution”.\textsuperscript{121}

### 3.3.3 A Complex Market - the Automobile Industry

The nature of transfer pricing involves a compliance with the rules of at least two tax jurisdictions, but complex supply chains can lead to the involvement of an even larger number of tax jurisdictions.\textsuperscript{122} For instance, the automobile industry provides an interesting example of a complex transfer pricing environment, which generally includes a high vertical integration\textsuperscript{123} MNE group atmosphere and usually involve contributions of valuable intangible assets made by two or more MNEs.\textsuperscript{124}

This illustration presents an example of a highly integrated and complex market. A German MNE, an automobile original equipment manufacturer (manufacturer), buys parts which are used in the manufacturing process from MNE in France and China. Moreover, the manufacturer is charged for a license fee in order to use a unique production technique which is owned by a MNE in the USA. The special technique, i.e. a valuable intangible, is a successful result from an expensive R&D project undertaken by the MNE located in the USA. Moreover, the MNE group has a service center in form of a MNE located in Switzerland. This latter MNE is specialized in marketing activities among some other routine functions and charge all the other MNE within the group of MNEs service and royalty fees.\textsuperscript{125}

### 3.4 Choice of Transfer Pricing Method

#### 3.4.1 Background

Different TPM are used to compare eligible comparables from independent enterprises with eligible comparables from a controlled transaction.\textsuperscript{126} Both the OECD and the USA

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\textsuperscript{121} OECD, \textit{Transactional Profit Methods: Discussion Draft for Public Comment}, January 2008, [page. 29.], Para. 61.

\textsuperscript{122} Heinrich, Rolf., Hickman, Andrew., Luquet, Pascal., Tseng, Steven., “APAs: an efficient vehicle for the auto industry”, (KPMG) TP Week, 28 September 2007, p. 1.

\textsuperscript{123} OECD, \textit{Comparability}, [page.30-31.], Paras. 3, 6-7.

\textsuperscript{124} PricewaterhouseCoopers, “\textit{Transfer Pricing in the Automotive Industry}”, Global Transfer Pricing Perspectives, Europe, Autumn 2007, pp. 48-50.

\textsuperscript{125} Ibid. and Heinrich, Rolf., Hickman, Andrew., Luquet, Pascal., Tseng, Steven., “APAs: an efficient vehicle for the auto industry”, (KPMG) TP Week, 28 September 2007, p. 1.

\textsuperscript{126} Please see the TPG, Paras. 1.15, 1.68-1.70, 2.1 and 3.1-3.4.
has prescribed a “method hierarchy” where some of the transfer pricing methods should preferable be applied instead of another, if possible.\footnote{OECD – “Most appropriate method”, the USA - "Best Method Rule" - USA Transfer Pricing Regulations (1994), Treas. Reg. Sec. § 1.482-1(e)(1).}

### 3.4.2 Method hierarchy

The OECD considers some transfer pricing methods to be more direct and thus more reliable than others.\footnote{TPG, Para. 2.5. and see also Paras. 3.1-3.2.} If two methods with a different rank in the hierarchy system would be applicable in an equally manner should the one with the highest rank be used.\footnote{Ibid. and OECD, Transactional Profit Methods: Discussion Draft for Public Comment, January 2008, [pages. 6-7.], Paras. 7 and 10.} When equally reliable, the Comparable uncontrolled price method (CUP) is preferable. Secondly, the Resale price method (RPM) and the Cost plus method (C+) has preference over the PSM and TNMM.\footnote{Id. Please see Chapter 4 for a short description of these methods and Chapter 5 for a more detailed description regarding the Profit Split Method (PSM).} According to Swedish legislation, the PSM is superior the TNMM.\footnote{Swedish Tax Authority, Supervision for International Taxation (2009), p. 264.}

Some of the TPM are more flexible than others, but also considered more or less reliable.\footnote{Please see the TPG, Paras. 1.15, 1.68-1.70, 2.1 and 3.1-3.4.} For instance the PSM, which can be employed to assess transfer prices where no sufficient comparable(s) can be obtained, \textit{e.g.} due to inaccessibility or reliability of available comparable information.\footnote{TPG, Para. 6.26.} However, if another method under the same circumstances (by taking the broad-base and functional analyses into account) could be applied in an equally reliable manner, that method should be applied instead except for the TNMM.\footnote{TPG, Para. 2.5. and see also Paras. 3.1-3.2. Moreover, please see OECD, Transactional Profit Methods: Discussion Draft for Public Comment, January 2008, [pages. 6-7.], Paras. 7 and 10.} This method will be described shortly below.\footnote{Please see Chapter 4.3.2.}

Under the USA viewpoint, the choice of a suitable TPM to assess arm’s length transfer prices “[m]ust be determined under the method that, under the facts and circumstances, provides the most reliable measure of an arm’s length result. Thus, there is no strict priority of methods, and no method will invariably be considered to be more reliable than others.”\footnote{USA Transfer Pricing Regulations (1994), Treas. Reg. Sec. 1.482-1(c).}

To conclude, both the OECD and the USA standpoint concerning the choice of applying “the most appropriate” or “the best” transfer pricing method rely on available and reliable comparables which can be used to reflect the transfer pricing situation, taking the broad-base and functional analysis into account. The main difference in the two hierarchy approaches is that the USA requires the taxpayer to “test” all available methods in order to
find out which one provides the most reliable arm’s length measure. The OECD does not require the taxpayer to use apply more than one method (i.e. the most appropriate) unless the taxpayer voluntarily consider the use of two methods to be more appropriate. However, the OECD approach should not be misinterpreted as if a single TPM automatically can be applied to all controlled transactions.

3.4.3 The Use of Multiple Methods

The OECD provides an option to use two or more methods in order to assess an acceptable transfer price. If none of the methods can provide a satisfying and reliable result, i.e. if arm’s length provisions for the controlled transaction cannot be readily set under one method only, an alternative is to apply an additional method. For example, if a transfer price is subject of being assessed for the very first time it can be argued that various methods all provides indications of different arm’s length results. Thus, a controlled transaction might be at arm’s length if the outcome lies within that range of results. The multiple employments of different methods can also be used to check an already determined outcome of an already applied method, i.e. sanity check. This can for instance be useful in order to evaluate a transfer price which has already been assessed in a very recent year to check the consistency of a relevant period of time. The establishment and documentation of a transfer pricing policy is an on-going process and not a solitarily occasion. Furthermore, in complex cases for instance when two or more MNE contributes with two different valuable intangible assets, the PSM can be used in conjunction with one or more other suitable TPM, e.g. as a first stage of PSM residual analysis.

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138 TPG, Para. 1.69. Please also see OECD, Transactional Profit Methods: Discussion Draft for Public Comment, January 2008, {pages. 17-18, 22.}, Paras. 17-24 and 40.
140 For instance, please see the TPG, Paras.1.69. and 3.50.
141 TPG, Para. 1.45.
142 OECD, Transactional Profit Methods: Discussion Draft for Public Comment, January 2008, {page. 20.}, Para. 29.
143 OECD, Transactional Profit Methods: Discussion Draft for Public Comment, January 2008, {page. 21.}, Para. 37.
144 PricewaterhouseCoopers, Internal Transfer Pricing 2009, p. 96.
145 Preferably a traditional transaction method (TPG 3.20) which is being described in Chapter 4, but the TNMM is most commonly used in practice when applying a PSM residual approach.
3.5 Comparability Analysis

3.5.1 Background

Not only can the authoritative statement of the ALP be found in Article 9 of the MTC. This article also constitutes the foundation of a comparability analysis\(^{147}\), which can be seen as "[a] comparison of a controlled transaction with an uncontrolled transaction. (...)", according to the OECD.\(^{148}\) Transfer prices in accordance with the ALP are established under a comparison of conditions between a controlled transaction and an uncontrolled transaction.\(^{149}\)

In order for the comparison to be reliable and useful, emphasis must be on put on the characteristics which are economically significant in the controlled- and uncontrolled transactions under review.\(^{150}\) Reliable comparables which can be used in the method applying process depends on the specific facts and circumstances of the transfer pricing situation, \textit{i.e.} the search for and usable comparables is adapted due to the results from the broad base and functional analysis.\(^{151}\) The OECD read up on five comparability factors which are considered to provide useful information determining the comparability of a controlled transaction. These are:

1. Characteristics of property or services\(^{152}\)
2. the functional analysis\(^{153}\)
3. contractual terms\(^{154}\)
4. economic circumstances\(^{155}\)
5. business strategies\(^{156}\).

The USA has prescribed five similar general factors and "[w]hile a specific comparability factor may be of particular importance in applying a method, each method requires analysis of all the factors that affect comparability under that method. Such factors include the following--

1. functions;
2. contractual terms;

\(^{147}\) OECD, \textit{Comparability}, [pages. 4 and 8], Paras. 1-3 and 22.

\(^{148}\) TPG, Glossary.

\(^{149}\) TPG, Para.1.15.

\(^{150}\) Ibid.

\(^{151}\) TPG, Paras. 1.17-18. \(\rightarrow\) TPG, Chapter 2-3.

\(^{152}\) TPG, Para. 1.19.

\(^{153}\) TPG, Paras. 1.20-1.27.

\(^{154}\) TPG, Paras. 1.28-1.29.

\(^{155}\) TPG, Para. 1.30.

\(^{156}\) TPG, Paras. 1.31-1.35.
(3) risks;
(4) economic conditions; and
(5) property or services.”

3.5.2 Internal and External Comparables

There are two different types of comparables; internal and external. Although transfer pricing regulations do not apply on transactions between an AE and an unassociated enterprise, (the latter also known as a “third party” or “unrelated party”), these transactions may be of relevance regarding comparability in terms of “internal comparables”.

Internal comparables can be extracted information from one of the AE annual income statement or balance reports. The OECD considers internal comparables to be a useful and reliable source of information in order to establish transfer pricing in accordance with the ALP, prerequisite that the obtained information comply with the five factors. External comparables are comparable information which is found in comparable uncontrolled transactions between independent enterprises and are more frequently utilized by practitioners nowadays. A search for reliable information is usually gathered from private and public databases. An example of a private database is Amadeus which consist of European independent enterprises. Another public database is Orbis, which consists of enterprises worldwide. An example of a national public database is Fame which consists of British and Irish public and private enterprises. Though, external reliable data are hardly ever found in public databases in practice.

In general, the OECD regards internal comparables to have preference over external comparables because internal comparables are considered to be more reliable. Thus, in order to employ a PSM, the OECD encourages a taxpayer to broaden the search for comparable uncontrolled transactions if the comparability analysis is confronted with the lack of satisfactory reliable comparables. Though, reliable comparables cannot always be found due to the complexity of the situation. Certain business environments are known to be more complex than others in terms of high integrity and consist of numerous intra-group transactions involving one or more contributions of intangible property. For instance the above described automobile industry.

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157 USA Transfer Pricing Regulations (1994), Treas. Reg. Sec. 1.482-1(d)(1)(i-v)
159 OECD, Comparability, [page. 18.], Para. 1.
160 OECD, Proposed revision of Chapters I-III, [page.39.], Para. 2.95.
161 OECD, Comparability, [page. 19.], Para. 12.
162 OECD, Comparability, [page. 19.], Para. 7.
163 Information about this database can be accessed at: (http://portal-live.solent.ac.uk/library/leaflets/resources/CD84.pdf).
164 OECD, Comparability, [page. 18.], Para. 12.
165 OECD, Comparability, [page. 31.], Para. 12.
166 Please see section 3.3.3.
Many MMEs experience that the absence of comparable transactions is one of the greatest problems they come across while establishing a comparability analysis. If a taxpayer performs a proper comparability analysis but cannot obtain reliable comparable information, might the employment of a transactional profit method (such as the PSM) provide a solution to establish a correct transfer price. There is a correlation between the expanding globalization and the lack of reliable information on independent transactions which may be suitable to use as comparables. Despite the fact that comparables not always can be obtained, the OECD state that it necessary to always find a solution for all transfer pricing situations. The search for comparables should be put in the light of which costs that will occur for the taxpayer to obtain the required information and in practice can these costs can be an issue for MNE of all sizes. Useful information which might be necessary to document can be the structure of the MNE group. Intangible assets and other ownership linkages within the group and the amount of sales and operating from the last previous years before the controlled transactions under review is examined, among other relevant information can also be helpful.

3.5.3 Intangible Property - Brief Notifications

When performed functions consist of intangible property it will most likely become an issue for both taxpayers and tax authorities to evaluate these contributions. According to the OECD can the same principles which are used in order to value tangible property and services, also be used to assess a correct value of intangible property. The OECD viewpoint is different from the USA, which recommend special TPM to be employed for intangible property. Another difference is the OECD and USA standpoint of different kinds of intangible property, which can be either Trade- or Marketing intangibles, according to the OECD. The USA regulations read up on six different kinds of intangible property classifications.

The OECD admits that it usually is difficult to obtain reliable comparables in complex situations and especially when one or more taxpayer owns an intangible which is a value-driver, for instance unique contributions. Under such circumstances may PSM be the most appropriate to employ because it can determine transfer prices of valuable intangible

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167 OECD, Comparability, [page. 30.], Para. 4.
168 TPG, Para. 3.6.
169 OECD, Comparability, [page. 31.], Para. 11.
171 OECD, Proposed revision of Chapters I-III, [Page. 71], Para. 379.
172 TPG, Para. 5.18.
173 TPG, Para. 6.13.
175 TPG, Para. 6.3.
177 Markham, Michelle, Transfer Pricing of Intangible Assets in the US, the OECD and Australia: are Profit Split Methodologies the Way Forward?, p. 20.
property in accordance to the ALP, provided that practical issues which arise during the PSM application can be managed.\textsuperscript{178} For instance, a PSM split the actual profit and none of the involved MNE will thus end up with an unreasonable amount of profit due to the miscalculated valuation of the intangible property.\textsuperscript{179}

\textsuperscript{178} TPG, Para. 6.26.

\textsuperscript{179} TPG, Para. 3.7.
4 Transfer Pricing Methods

4.1 Introduction

This chapter is a short overview of different transfer pricing methods that are used to establish transfer prices within an arm’s length. TPM recommended by the OECD and by the USA will be described in order to point out some differences in various approaches of how to determine a reliable transfer price. Moreover, a short explanation of the OEDC and USA different opinions of method hierarchy will also be read upon.

In order to determine arm’s length conditions on controlled transactions, various transfer pricing methods can be applied in order to compare the transaction(s) under review with the reliable information collected in the comparability analysis. Depending on the specific facts and circumstances of the case, the various TPM are more suitable than the others from time to time. Sometimes it may also be suitable to use two or more methods to get a range of different transfer prices which all may be acceptable.

4.2 OECD Traditional Methods

4.2.1 Background

Three of these methods are called the “traditional transaction methods” and two of them are called “transactional profit methods”. The OECD recognises that AE often are unavailable to apply a traditional transaction method in practice due to the lack of reliable information of independent enterprises (third party data/information). All of the OECD methods can more or less be applied in various ways and also with the possibility of being adjusted, if appropriate.

4.2.2 One-Sided and Two-sided Methods

Three of the OECD methods can be seen as “one-sided” methods; the RPM, C+ and TNMM. A one-sided method can be explained as a method which put main focus on one of the AE in the controlled transaction under review. A common feature with these three methods is that they mainly examine the least complex of the two AE, i.e. the “tested party”. This party is then compared to a comparable unrelated company which operates under similar circumstances.

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180 Please see above in Chapter 3.
181 Please see above in Chapter 3.
183 OECD, Comparability, [page. 31.], Para. 11. With reference to TPG, Paras. 1.15 (general information), 2.7-2.9 (regarding CUP), 2.16 (regarding RPM), 2.34 (regarding C+), and 3.2, 3.39 (regarding TNMM).
184 OECD, Proposed revision of Chapters I-III, [page.58.], Para. 3.20.
186 Ibid, [page. 44.], Para 151.
Regarding the two remaining methods, the CUP and PSM, they are considered to be “two-sided” methods, since these methods put emphasis on both of the involved companies in the controlled transaction. However, in reality one can say that all of the methods are two-sided but the RPM, C+ and TNMM methods put more focus on the AE which is more likely to be compared with an unrelated enterprise.\(187\) A positive feature with a PMS is the methods ability to offer a solution where a one-sided method would be inappropriate to employ.\(188\)

### 4.2.3 Comparable Uncontrolled Price Method

According to the OECD, a CUP is the most direct method to determine whether the remuneration for a controlled transaction is at arm’s length.\(189\) When CUP can be applied it is preferable over any other transfer pricing method.\(190\) The use of CUP method compares the price of the controlled transaction with the price of an exact or similar uncontrolled transaction, \textit{i.e.} an uncontrolled transaction is comparable if there are material no differences affecting the price or if reasonably accurate adjustment can be made.\(191\) As two transactions are in focus, it is important to emphasize that the compared transactions should be of exact or similar nature in matter of material differences in order to be comparable, otherwise another method might be more suitable to use.\(192\) Typical transactions in where CUP is applied can for instance be in the financial area, where reliable information easily can be found on third party prices such as interests rates.

One could say that there are four different types of CUP which could be divided into two categories, Internal- and External CUP which could either be considered as exact or inexact CUPs.\(193\) Whether the CUP is internal or external depends on the compared uncontrolled transaction. An Internal CUP compare the prices from two transactions of the taxpayers; one controlled transaction and one uncontrolled transaction with a third party.\(194\) The external CUP instead compares the price in the taxpayers controlled transaction with the price of an uncontrolled transaction between two independent parties. Depending on whether the prices from one or both of the transactions are adjusted or not, the internal or external Cup will be considered either exact (unadjusted) or inexact (adjusted). In practice, internal CUPs are in principal always used since external CUPs cannot be applied due to lack of reliable information.

\(187\) OECD, \textit{Proposed revision of Chapters I-III}, [page.57.], Para. 3.18.

\(188\) OECD, \textit{Proposed revision of Chapters I-III}, [page.58.], Para. 3.20.

\(189\) For instance, please see TPG, Paras. 2.7 and 2.9.

\(190\) TPG, Para. 2.7.

\(191\) For instance, please see TPG, Paras. 2.6-2.7.

\(192\) For instance, please see TPG, Para. 2.11.

\(193\) TPG, Para. 2.5.

4.2.4 Resale Price Method

The Resale Price Method (RPM) is most commonly applied on transactions undertaken by a retailer/reseller/distributor company. Although the OECD consider the method to be transactional, much focus will be on the performed functions of the involved companies instead of the charged price or if comparable uncontrolled transactions involve the same product or service.\(^{195}\) The functional analysis will therefore be of importance in order to find adequate comparisons in order for the controlled transaction to comply with the arm’s length principle under the RPM. Reliable and suitable comparables can thus be found at third party companies which operate under exact or similar circumstances, \textit{i.e.} unrelated parties which carry out exact or similar functions and undertaken risks.\(^{196}\) Moreover, adjustments may be suitable to be made regarding performed functions, costs and undertaken risks, instead of the charged price.\(^{197}\)

This characteristic depends on the fact that RPM put emphasis on the comparability of the resellers “resale price margin”, \textit{i.e.} gross margin, since functions and risks are more relevant for comparison of profit margins than the products or services themselves.\(^{198}\) RPM operates backward as it examines the charged price of the controlled transaction between the reseller company under review (tested party) and other AE (non-tested party) which the reseller company bought the product or service from.\(^{199}\) The resale price is the non-tested party’s charged price to an independent enterprise and RPM is prone to be used when the reseller AE does not add any substantially value to the resold product or service and can be useful to set transfer prices concerning marketing operation.\(^ {200}\)

4.2.5 Cost Plus Method

C+ is commonly used to set transfer prices of a tested party which mainly performs contract manufacturer functions, \textit{i.e.} provides products or services to other MNE.\(^ {201}\) For instance, C+ may be most useful for sales of semi-produced goods and services. A transfer price in accordance with the ALP is assessed when an appropriate mark-up is added to the cost which has incurred by the tested parties in the controlled transaction.\(^ {202}\) The cost bases must be comparable with an independent enterprise and reliable comparables may be found by using internal comparables, for instance a percentage which is earned by the tested party in comparable uncontrolled transactions.\(^ {203}\) The cost base can also be based on a functional comparison using external comparables, where the tested party’s functions is being compared with an independent enterprise which may be selling different goods or services, but

\(^{195}\) TPG, Para. 2.19.

\(^{196}\) For instance, please see TPG, Paras. 2.14-2.15 and 2.19.

\(^{197}\) TPG, Para. 2.21.

\(^{198}\) TPG, Para. 2.16

\(^{199}\) TPG, Para. 2.14.

\(^{200}\) TPG, Paras. 2.14. and 2.22.

\(^{201}\) TPG, Para. 2.32. and PricewaterhouseCoopers, \textit{International Transfer Pricing 2009}, p. 27.

\(^{202}\) Ibid.

\(^{203}\) PricewaterhouseCoopers, \textit{Internal Transfer Pricing 2009}, p. 27.
function with similar contributions, risks assets.\(^{204}\) In order to decide whether to use a RPM
or C+ to use depends on the available comparables which are the most reliable.\(^{205}\)

4.3 OECD Transactional Profit Methods

4.3.1 Background

Over the last 14 years, a more frequent use of transactional profit methods in practice has
been acknowledged in an increasing number of OECD Member Countries.\(^{206}\) One explanation
could be that MME group tend to be more integrated nowadays on a vertical level.
Thus, each MNE within that group will practically be harder to compare with independent
companies since no reliable comparables can be obtained. For instance, because such inde-
pendent comparable companies might not exist since they all are vertically integrated within-
in different MNE Groups, which all operates in the same market.\(^{207}\) Moreover, it is more
common today that the cross-border transactions involve contributions of intangible prop-
erty, sometimes provided by two or more of the AE.\(^{208}\)

4.3.2 Profit Split Method

In brief, OECD mainly read up on two different profit split approaches/analyses; the con-
tribution and the residual profit split.\(^{209}\) This chapter is just an overview of OECD methods
and USA methods. As the main purpose of this thesis is to examine whether the use of
profit split methods will have a tendency to increase in the near future, the entire upcoming
chapters will provide thorough presentation about different types of PSM approaches.

4.3.3 Transactional Net Margin Method

The TNMM examine the net profit margin which arises from a controlled and weight this
profit against an appropriate base.\(^{210}\) Thus, the appropriate net margins may be different
depending on the facts and circumstances of the situation since suitable base can for in-
stance be costs, sales or assets. Usable net margins can be return on assets and operating in-
come but also other net margins may be appropriate.\(^{211}\) In practice, the operating profit are
usually weighted against operating expenses in order to assess an arm’s length net margin,
which can be used in a reliable comparison with an comparable net margin from an uncon-
trolled transaction. However, consideration must be taken since the net profit margin can

\(^{204}\) TPG, Para. 2.33.

\(^{205}\) TPG, Para. 2.24.

\(^{206}\) OECD, Transactional Profit Methods: Discussion Draft for Public Comment, January 2008, [page. 5.], Para. 2.

\(^{207}\) OECD, Comparability, [page. 30.], Para. 2.

\(^{208}\) Boos, Monica,. International Transfer Pricing: The Valuation of Intangible Asset, p. 10. See also TPG, Pa-
ra.3.5.

\(^{209}\) For instance, please see TPG, Paras. 3.5, 3.16.-3.18 (contribution analysis) and 3.19.-3.20 (residual analy-
sis).

\(^{210}\) TPG, Para. 3.26.

\(^{211}\) TPG, Paras. 3.26-3.27.
be affected by several of factors, such as management efficiency for instance, which not necessarily have an impact on the operating expenses.\textsuperscript{212}

A practical advantage with the TNMM is that the performed functions and the used comparables do not require being as similar as the traditional methods do. However, the OECD expresses concerns that the TNMM as a consequence might affect the reliability of the compared net profit margin in the comparison, due to possible material differences.\textsuperscript{213} Along with the PSM, the TNMM is still a method of last resort and should only be used when any of the traditional transactional methods can be used.\textsuperscript{214}

4.4 A Brief Presentation of the USA Methods

In general, the recommended TPM by the USA are more precise. Guidance can be found to apply the various types of methods on three different categories of controlled transactions; tangible property, intangible property and services.\textsuperscript{215} Some of these methods are different from the methods recommended by the OECD and the USA regulations also consist of a larger number of transfer pricing methods. Henceforth, some brief notifications regarding the USA methods which are exact or similar to the above described OECD methods (CUP, RPM, C+, PSM and TNMM) will be presented.

The USA method “Comparable Uncontrolled Transaction” (CUT) method is in practice the same method as the CUP. This method should preferable be used when the controlled transaction involves an American enterprise and when the controlled transaction under review involve an intangible or service. Another USA method, the “Comparable Profit Method” (CPM), has its equivalent in the OECD method TNMM. Moreover, the USA and OECD both provide options to apply the RPM and C+ methods. Regarding the RPM and the C+, the company which is the “least complex” part of the two involved AE in the controlled transaction should be the tested party, for instance the reseller when applying the RPM.\textsuperscript{216} Regarding the USA profit split methods, the difference from the OECD is that the USA does not present a contribution approach but provide a comparable profit split instead. The residual approach can be employed under both the OECD and the USA.

The best\textsuperscript{217} of six different methods should be used when an arm’s length price for controlled transactions of tangible property is determined.\textsuperscript{218} All of the OECD methods, except for the TNMM can be used. Instead, the USA provides an option of using the CPM and “unspecified methods” in contrast to the OECD. Four different methods can be applied to assess an arm’s length price for controlled transactions of intangible property and nine methods for controlled transactions of services.

\textsuperscript{212} TPG, Paras. 3.34-3.35.

\textsuperscript{213} TPG, Paras. 3.27-3.28. Also see PricewaterhouseCoopers, \textit{Internal Transfer Pricing 2009}, p. 33.

\textsuperscript{214} TPG, Para. 2.49.

\textsuperscript{215} USA Transfer Pricing Regulations (1994), Treas. Reg. Sec. § 1.482-3(a)(1-6).

\textsuperscript{216} USA Transfer Pricing Regulations (1994), Treas. Reg. Sec. § 1.482-5.

\textsuperscript{217} Please see above regarding the USA method hierarchy “the best method rule”.

\textsuperscript{218} USA Transfer Pricing Regulations (1994), Treas. Reg. Sec. § 1.482-3(a)(1-6).
4.5 Recent Developments at the OECD

On September 9 (2009) the OECD issued a Proposed Revision of Chapters I-III of the Transfer Pricing Guidelines (Proposed Revision). In brief, the existing TPG read up on two categories of TPM. These are the Traditional Transaction Methods and can be found in Chapter II of the TPG and consists of the CUP, RMP and C+. The other category is the Transactional Profit Methods (described above) which can be found in Chapter III of the existing TPG and consists of the PSM and TNMM. In the existing TPG, the latter category of TPM should only be employed in exceptional situation where the traditional methods cannot provide an appropriate arm’s length result, for instance due to lack of reliable comparables. However, in the Proposed Revision “[t]he OECD proposes to removing exceptionality and replacing it with a standard whereby the selected transfer pricing method should be the “most appropriate method to the circumstances of the case”.219

The Proposed Revision will also provide some additional developments. For instance, the guidance which can be found regarding the comparability analysis will be updated and further will be provided on the application of the PSM and TNMM methods.220 The Proposed Revision is frequently used as a source in this master’s thesis along with the OECD, Comparability: Public Invitation to Comment On A Series Of Draft Issues Notes (May 10, 2006) and OECD, Transactional Profit Methods: Discussion Draft for Public Comment (January, 2008). These two latter developments of the OECD compose the foundation of the Proposed Revision.

4.6 Salient Points

The OECD recommend the taxpayer and tax authorities five different transfer pricing methods which can be used to determine a correct arm’s length price. In general, the factor which characterizes the OECD methods is that they strive to put the main focus of the relevant economically conditions (e.g. price or a suitable gross- or net margin)221 in the controlled transaction(s) under review. Moreover, the OECD does not favour that their recommendations of using a method should be a rigid set of criteria which should be interpreted restrictedly. The USA at the other hand, are keener to emphasize on the made profit arisen from the controlled transactions at a profit-intermediary level e.g. the overall taxable profits.

To sum up, the factors which characterizer the OECD methods are that they strive to put the main focus on the actual (controlled) transaction. The USA at the other hand, are keener to emphasize on the made profit arisen from the controlled transactions at an intermediary profit level. However in practice, especially when applying the TNMM, the CPM and TNMM are being applied in a very similar way and can thus be considered as the same method but with two formally different names.

219 OECD, Proposed revision of Chapters I-III, [page.2.], with reference to Paras. 2.1.-2.9.

220 OECD, Proposed revision of Chapters I-III, [page.2.].

221 TPG, Para. 1.15.
5 Profit Split Methods

5.1 Introduction

This chapter will provide a thorough presentation of the PSM and three different PSM approaches. The first two are the contribution PSM of the OECD and the comparable PSM of the USA. The third approach, the residual PSM, is regulated under both the OECD and USA under very similar conditions.\textsuperscript{222}

In general, it is the combined operating profit (\textit{i.e.} EBIT)\textsuperscript{223} which is subject to be split.\textsuperscript{224} Another possibility is to utilize the gross profit in appropriate situations, for instance due to the availability of reliable comparables.\textsuperscript{225} The use of gross profit is however uncommon in practice and operating profit is generally preferred by the OECD\textsuperscript{226} and required to be utilized under the USA regulations\textsuperscript{227}. Therefore, this master’s thesis excludes the use of gross profits in employment of any PSM approach.

5.2 Three Typical Profit Split Transfer Pricing Situations

There are certain situations where a PSM might be the most appropriate method to apply, in order to assess that undertaken controlled transactions complies with the arm’s length principle.\textsuperscript{228} Nevertheless, there are three typical transfer pricing situations where PSM will probably provide the most appropriate arm’s length result. Firstly, the PSM can provide a solution in situations where the controlled transactions under review involves operations of high integration and a one-sided method such as the RPM, C+ or TNMM would not be appropriate to employ.\textsuperscript{229} Secondly, in situations where two or more MNEs perform functions which involves unique contributions or valuable for which no reliable comparables can be obtained, for instance intangibles.\textsuperscript{230} On the contrary, a PSM would probably not be appropriate to employ in cases where only routine functions are performed for which

\textsuperscript{222} Please see the TPG, Chapter III (the OECD Contribution PSM and Residual PSM). And the USA Transfer Pricing Regulations (1994), Treas. Reg. Sec. § 1.482-6 (USA Comparable PSM and Residual PSM).
\textsuperscript{223} The OECD generally refers Operating Profit to "operating profits before exceptional items, interest and tax. OECD, Transactional Profit Methods: Discussion Draft for Public Comment, January 2008, [page. 61.], Para. 202. Operating Profit can also be defined as "A measure of a company’s earning power from ongoing operations, equal to earnings before deduction of interest payments and income taxes, also called EBIT (Earnings Before Interest and Taxes) or operating income." (http://www.investorwords.com/3464/operating_profit.html)
\textsuperscript{224} OECD, Transactional Profit Methods: Discussion Draft for Public Comment, January 2008, [page. 57.], Para. 185 (In general, operating profits are subject to be split under both the Contribution and Residual PSM. Please see Chapter 6 for further reading).
\textsuperscript{225} OECD, Transactional Profit Methods: Discussion Draft for Public Comment, January 2008, [page. 60.], Para. 200.
\textsuperscript{226} Ib. Paras. 198 and 199.
\textsuperscript{227} Please see 5.3 regarding the USA Comparable and Residual PSM.
\textsuperscript{228} OECD, Proposed revision of Chapters I-III, [page. 32.], Para. 2.69.
\textsuperscript{229} OECD, Proposed revision of Chapters I-III, [page. 31.], Para. 2.63.
comparables can be found and utilized in another more appropriate TPM.\textsuperscript{231} Thirdly, a PSM might be the most appropriate method to employ when the controlled transactions which contain contribution(s) of significant value, \textit{i.e.} high value-driver functions which usually can be attributed in forms of unique assets for which no comparables cannot be found.\textsuperscript{232}

5.3 The OECD Profit Split Method

5.3.1 OECD – PSM History

In the years between 1979 and 1995, the OECD had a reluctant standpoint of accepting the application of any transfer pricing method based on profits, such as the PSM.\textsuperscript{233} This hesitant viewpoint changed in the TPG from 1995 which explicitly stipulates that the PSM could provide a transfer pricing estimation in accordance with the ALP, which should be accepted in some exceptional cases in order to respect the “complexities of real life business (…)”.\textsuperscript{234} For instance, in cases where no comparables can be obtained in order to assess transfer prices with any of the traditional methods in a reliable manner, \textit{e.g.} due to very interrelated controlled transactions under review which also might comprise highly value intangibles.\textsuperscript{235} The fact that OECD insist of using comparables to the highest extent as possible when employing the PSM entails practical problems, since it is rather a rule than an exception that reliable comparables cannot be found when valuable intangibles are involved.\textsuperscript{236}

5.3.2 Background – General Guidance

A PSM can be employed to either establish an arm’s length remuneration of controlled transactions or to check an already set transfer price, \textit{i.e.} sanity check.\textsuperscript{237} It might be worth to point out the PSM just provides a solution in the question of how profits should be split and not whether the profits (after being allocated) should be taxed, which is a question under domestic law.\textsuperscript{238}

Two tasks are encountered when a PSM is employed. The first task is to assess “the amount of profits” which arises from the controlled transactions under review.\textsuperscript{239} For instance, if

\begin{itemize}
\item \textsuperscript{231} OECD, \textit{Proposed revision of Chapters I-III}, [page. 31.], Para. 2.63.
\item \textsuperscript{232} OECD, \textit{Proposed revision of Chapters I-III}, [page. 31.], Para. 2.63. and Markham, Michelle, \textit{Transfer Pricing of Intangible Assets in the US, the OECD and Australia: are Profit Split Methodologies the Way Forward?}, p. 21. See also TPG, Para. 6.26.
\item \textsuperscript{233} Markham, Michelle, \textit{Transfer Pricing of Intangible Assets in the US, the OECD and Australia: are Profit Split Methodologies the Way Forward?}, pp. 7-8 and 15.
\item \textsuperscript{234} TPG, Paras. 3.1–3.2.
\item \textsuperscript{235} TPG, Paras. 3.1–3.5.
\item \textsuperscript{236} Markham, Michelle, \textit{Transfer Pricing of Intangible Assets in the US, the OECD and Australia: are Profit Split Methodologies the Way Forward?}, pp. 16 and 19. Also, please see TPG, Para. 2.49.
\item \textsuperscript{237} OECD, \textit{Proposed revision of Chapters I-III}, [page. 28.], Para. 2.10-2.11.
\item \textsuperscript{238} OECD, \textit{Transactional Profit Methods: Discussion Draft for Public Comment}, January 2008, [page. 55.], Para. 183.
\item \textsuperscript{239} OECD, \textit{Proposed revision of Chapters I-III}, [page. 30.], Para. 2.61.
\end{itemize}
MNE (A) raise 10 units of profits and MNE (B) raises 5 units of profits, the combined profits (i.e. total profits) to be split is 15 units. Alas, the TPG lack to describe in detail and do not provide much assistance in how to assess the combined profits. After the combined profit has been assessed, the upcoming task which is to determine how the profits should be split. The overriding objective should be a split according to the ALP, i.e. the split should reflect an allocation which independent enterprises should have agreed upon under comparable circumstances and conditions. This second task can be made in different approaches according to the OECD; the contribution or the residual. Also other approaches can be accepted if they are compatible with the ALP. These “other” approaches are delimited from this master’s thesis.

5.3.3 Contribution PSM

Under a contribution PSM, the combined profits equal “[t]he total profits from the controlled transactions under examination”, which should be established on an economically valid basis. The relevant controlled transactions need to be identified before the total profits can be evaluated. This includes the possible issue of identifying to which extent the controlled transactions under review are aggregated, if that is the case.

When the total profit from the transactions under review has been established it should be allocated among the involved companies. The division of profits is based on the relative and economically value of the performed functions of each involved MNE, i.e. an arm’s length allocation is determined by the level of value which a contribution entails to the total profits. In practice, the profit is allocated among the involved companies in relation to the extent which performed contributions have created value or the total profit supported by reliable “allocation keys”. Hence, the functional analysis can provide key information in order to identify and assign the contribution which has been actually undertaken by the involved MNE. The relative value of the companies contributions should preferable be supported with as much reliable external comparables as possible, unless the relative value can be assessed by using internal comparables, i.e. measured directly.

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243 Id. For instance, please also see the TPG, Paras.3.1, 3.3.

244 OECD, *Proposed revision of Chapters I-III*, [page. 33.], Para. 2.73.

245 OECD, *Proposed revision of Chapters I-III*, [page. 32.], Para. 2.70.


249 OECD, *Proposed revision of Chapters I-III*, [page. 33.], Para. 2.73. See also TPG, Para. 3.16.
Generally, it is the joint operating profits from the controlled transactions under review which are subject to be allocated among the AE. 250 Hence, the relevant expenses and incomes are counted for each involved MNE when the operating profits are being measured.251 However, instead of split operating profit it may sometimes be more suitable to allocate the “gross profits”252. When the gross profit is allocated should every involved MNE deduct the expenses incurred in or attributable to the received share of gross profit, from the relevant controlled transactions. 253

Whether a “correct” valuation is accomplished or not will most likely depend on the specific facts and circumstances of the case. When an arm’s length evaluation is assessed by external comparables “[t]he determination might be made by comparing the nature and degree of each party’s contribution of differing types (for example, provision of services, development expenses incurred, capital invested) and assigning a percentage based upon the relative comparison and external market data”. 254 A typical business industry where a contribution PSM could be the most appropriate method to employ is in the area of financial services.

5.3.4 Residual PSM

The residual approach is an analysis made in two steps.256 Firstly, the taxpayers should combine the division of profits arising from the identified controlled transactions under review, which can be found in broad-base analysis. Thereafter, when the total profit from the controlled transactions has been assessed, should the remunerations for routine functions, i.e. low value driver functions should be subtracted. The remuneration for the routine functions (i.e. non-unique functions) is usually assessed by another “most suitable” TPM.257 As a consequence, after the sum of remunerations has been subtracted from the total profits, a residual profit remains which cannot be readily attributed to one company.258

The residual approach also seeks to split the total profits arising from the controlled transactions, according to the economical value of each contribution which are being performed by the involved MNEs. However, in order for a residual approach to be most appropriate to employ, two or more of the performed functions should generally be considered to be

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250 OECD, Proposed revision of Chapters I-III, [page. 36.], Para. 2.85. See also TPG, Para. 3.17.

251 Markham, Michelle, Transfer Pricing of Intangible Assets in the US, the OECD and Australia: are Profit Split Methodologies the Way Forward?, p. 14. With reference to TPG, Para. 3.17.

252 Gross profit can be defined as “Sales minus all costs directly related to those sales. Those costs can include manufacturing, expenses, raw materials labour, selling, marketing and other expenses”. (http://www.investorwords.com/2249/gross_profit.html)

253 TPG, Para. 3.17.

254 TPG, Para. 3.18.


257 OECD, Proposed revision of Chapters I-III, [page. 34.], Para. 2.75.

258 Ibid.
“unique contributions”. The OECD defines “unique contributions” to be “[n]on-benchmarkable functions, assets or risks for which no sufficiently reliable comparables can be found”. As these contributions are unique in their nature they cannot be economically assessed in accordance to the ALP because reliable comparables are not obtainable. Thus, the entire total profits cannot be readily assigned to the involved MNEs since the economical value of each contribution cannot be assessed. The remuneration for contributions which can be evaluated should be subtracted from the total profits and the leftover, i.e. the residual profit, should be allocated “[b]ased on an analysis of the facts and circumstances that might indicate how this residual would have been divided between independent enterprises”. Hence, the residual approach is therefore an analysis in two different steps.

A residual profit allocation can also be made in the light of independent companies “bargain position”. This approach is also made in two steps. In the first, after the combined division of profits has been determined, each participant (similar to the contribution PSM) should be remunerated the lowest price which could be found in an open market. Thereafter, one should seek to estimate the highest possible price on the open market and the discrepancy in between the lowest and the highest price would result in a residual profit. In step two should the allocation of residual profit aim to reflect the outcome of how independent enterprises under conditions at arm’s length. The allocation is based on the facts and circumstances of the specific case, similar to a “regular” residual PSM.

### 5.3.5 Pros and Cons

A positive aspect of every PSM approach is that they examine the controlled transactions under review in a prudent manner as it is a two-sided method where every involved MNE are evaluated. This PSM quality might especially be beneficial if the undertaken contributions involves intangibles made by two or more MNE, because no other transfer pricing methods than the PSM might be applicable. Thus, the PSM offers flexibility because it considers the specific facts and circumstances of the MNEs which cannot be found in comparable independent enterprises. Moreover, a real actual profit is being split which generally does not leave any of the involved MNEs with an unreasonable high profit, since each MNE is being appraised. Hence, it can very well be argued that “[T]he profit split method deserves a more prominent position than under the TPG, as it does not rely on comparables and offers solutions in situations where it is difficult to disentangle transactions between related parties.”

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261 TPG, Para. 3.19.

262 OECD, Proposed revision of Chapters I-III, [page.32.], Para. 2.76. Based on TPG, Para. 3.21.

263 OECD, Proposed revision of Chapters I-III, [pages. 31-32.], Paras. 2.63-2.66.

264 OECD, Proposed revision of Chapters I-III, [pages. 31-32.], Paras. 2.63-2.66.

265 OECD, Proposed revision of Chapters I-III, [page.32.], Para. 2.67.

On the other hand are there two fundamentally disadvantages with the PSM. First, the application of a PSM usually includes a week and sometime doubtful connection of external market data with the controlled transactions under consideration, which result in a comparison with a certain amount of subjectivity. Moreover, both taxpayers and tax administrations might find it hard to obtain reliable information from MNE in foreign countries. This inconvenience might materially affect the reliability of method since the profit should be an economical assessment based on each every undertaken function by the MNE, using preferable external comparables which can support the valuation.

5.4 The USA Profit Split Methods

5.4.1 USA History

The USA read up on two different PSM approaches in the 1994 regulations; the Comparable PSM and the Residual PSM. However, in 1993 it was projected to be four different PSM variations. The USA accepts the PSM method to be employed on controlled transactions of tangible and intangible property and services. An employment of the PSM is considered to be especially qualified for industries which usually comprise high-technology assets, e.g. the automobile industry.

5.4.2 Background – General Guidance

A general prerequisite for the application of the (USA) PSM is an estimation of the relative value of each MNEs performed contribution. Special considerations should also be given to entered risks and the expected return of profit which can be assigned to these ventures. It is the combined operation profit (or losses) from the controlled transactions under review which is subject to be split. The operating profit must be attributable to a controlled transaction and be reinforced with available information which can support the assessment of the operating profits. Moreover, segmentation of the controlled transactions is sometimes required since the operating profit must be derived from each MNEs “relevant business ac-

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267 OECD, Proposed revision of Chapters I-III, [pages. 31-32.], Para. 2.64. and Markham, Michelle, Transfer Pricing of Intangible Assets in the US, the OECD and Australia: are Profit Split Methodologies the Way Forward?, p. 14. with reference to TPG, Para.3.8.

268 OECD, Proposed revision of Chapters I-III, [page.32.], Para. 2.68. Also TPG, Paras. 3.2, 3.5 and 3.18.

269 USA Transfer Pricing Regulations (1994), Treas. Reg. Sec. § 1.482-6 (c)(i). And Markham, Michelle, Transfer Pricing of Intangible Assets in the US, the OECD and Australia: are Profit Split Methodologies the Way Forward?, p. 9.


271 Markham, Michelle, Transfer Pricing of Intangible Assets in the US, the OECD and Australia: are Profit Split Methodologies the Way Forward?, p. 9.

272 USA Transfer Pricing Regulations (1994), Treas. Reg. Sec. § 1.482-6 (a). And Markham, Michelle, Transfer Pricing of Intangible Assets in the US, the OECD and Australia: are Profit Split Methodologies the Way Forward?, p. 9.
tivity”, i.e. “[t]he most narrowly identifiable business activity of the controlled taxpayers for which data is available that includes the controlled transactions.”

When an appropriate amount of operating profit has been estimated it should be allocated among the participated MNEs. A proper share of the profits should be based on the relevant business activity. In other words, the evaluated contributions should correspond with the comparability provisions and reflect the conducts of the functional analysis including the used assets and assumed risks, under an arrangement which independent enterprises would have agreed upon. However, an appropriate share of profits does not mean that a MNE is restricted to receive an amount which equals the total profits of the relevant business activities. The profits should be shared according to the economically value of the performed contribution, which sometimes might be shared in a disproportionate manner. For instance, if one taxpayer makes profit in a given year and a loss incurs the upcoming year. This share of operating profit can either be made under a Comparable or Residual approach and the best approach to employ is determined under the best method rule, taking comparability and reliability into account.

5.4.3 Comparable PSM

Under a Comparable PSM, “[e]ach uncontrolled taxpayer's percentage of the combined operating profit or loss is used to allocate the combined operating profit or loss of the relevant business activity”. In order to find out whether this approach provides a reliable result, a comparison must be made between the divided operating profit which arises from the taxpayer’s relevant business activities and with comparable independent enterprises (which operates under circumstances) division of operating profit.

An important notice is that the contractual terms of the involved taxpayer’s in the relevant business activities should be comparable, since it is considered to be a primary factor in assessing the relevant allocation of functions and risks among the taxpayers.

Only data which are related to the relevant business activities should be utilized and data from the involved taxpayers other activities should be rejected. When the data is com-

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273 USA Transfer Pricing Regulations (1994), Treas. Reg. Sec. § 1.482-6 (a). And Markham, Michelle, Transfer Pricing of Intangible Assets in the US, the OECD and Australia: are Profit Split Methodologies the Way Forward?, p. 9.

274 Please see the USA Transfer Pricing Regulations (1994), Treas. Reg. Sec. § 1.482-1(d)(3) regarding the USA comparability standards.

275 USA Transfer Pricing Regulations (1994), Treas. Reg. Sec. § 1.482-6 (b).

276 USA Transfer Pricing Regulations (1994), Treas. Reg. Sec. § 1.482-6 (b).


278 USA Transfer Pricing Regulations (1994), Treas. Reg. Sec. § 1.482-6 (c)(2)(ii)(A) regarding the Comparable approach, and Treas. Reg. Sec. § 1.482-6 (c)(3)(ii)(A) regarding the Residual approach, both referring to “Best method Rule” which can be found in Treas. Reg. Sec. § 1.482-1(c).


pared with independent enterprises, dissimilar accounting standards such as differences in inventory and cost accounting, might materially affect the reliability of the allocation of operating profits.\textsuperscript{283} In such cases appropriate adjustments can be made if possible and appropriate.\textsuperscript{284}

A proper application of this approach relies solely on external market benchmarks, \textit{i.e.} on reliable comparable data which can be accessed on similar contributions, risks and used assets from independent enterprises.\textsuperscript{285} The reliability of this method can be considered to be enhanced since all the participants should be evaluated. However, a one-sided method might be more appropriate to employ if obtained data from one of the taxpayers is more reliable than the others.\textsuperscript{286} Finally, the USA regulations explicitly state that this approach is not appropriate to employ "if the combined operating profit (as a percentage of the combined assets) of the uncontrolled comparables varies significantly from that earned by the controlled taxpayers."\textsuperscript{287}

\section*{5.4.4 Residual PSM}

Under the residual approach is the combined operating profit (or loss) is divided among the involved taxpayers under a two-step process.\textsuperscript{288}

In step one should all functions for which comparables can be obtained to assess a market return, be remunerated by subtracting this amount from the combined residual. Routine contributions can be property of both tangibles and intangibles, but also services. Other TPM are employed to assess the routine contributions prerequisite that comparables can be obtained.\textsuperscript{289} Comparable contribution market returns for the routine functions should be similar to these functions, asset used and risks which can be identified through the functional analysis.\textsuperscript{290} In general, these contributions market returns for which comparables cannot be found are considered as non-routine functions. Because the remuneration for routine functions will not compensate the operating profit which can be attributed to non-routine functions, a residual profit will arise. Thus secondly, under step two, this residual should as reliable as possible be allocated among each participant’s contribution of non-routine function to the relevant business activity. The remuneration should be based on the relative value and a proper allocation of the remuneration should be reflected in the relevant business activities. For instance, the non-routine contribution might be used in other controlled transactions concerning other business activities.\textsuperscript{291}

\begin{thebibliography}{99}
\bibitem{283} USA Transfer Pricing Regulations (1994), Treas. Reg. Sec. § 1.482-6 (c)(2)(ii)(C)(2).
\bibitem{285} USA Transfer Pricing Regulations (1994), Treas. Reg. Sec. § 1.482-6 (c)(2)(ii)(D).
\bibitem{286} USA Transfer Pricing Regulations (1994), Treas. Reg. Sec. § 1.482-6 (c)(2)(ii)(D).
\bibitem{287} USA Transfer Pricing Regulations (1994), Treas. Reg. § 1.482-6 (c)(2)(ii)(B)(1).
\bibitem{288} USA Transfer Pricing Regulations (1994), Treas. Reg. § 1.482-6 (c)(3)(i).
\bibitem{290} USA Transfer Pricing Regulations (1994), Treas. Reg. § 1.482-6 (c)(3)(i)(A).
\end{thebibliography}
The second step might not involve the use of comparables, because all “possible” efforts and attempts to obtain reliable comparables (both internal and external) has been readily made, but cannot be found due to the uniqueness of the intangibles.\textsuperscript{292} If the non-routine contributions can be classified as an intangible property, the relative market value can be measured be reliable external comparables, \textit{i.e.} benchmarks of intangible property which can be obtained from independent enterprises. As an alternative, the developing cost of the non-routine intangible including related costs of improvements and updates subtracted with a proper amount of depreciation based on the intangibles estimated life time, could also be used to assess the relative value. Lastly, as a third alternative, prerequisite that more than one taxpayer has both capitalized intangible development and benefited from it in similar manners; the actual spent amount of costs in the recent years can be used to assess the relative value.\textsuperscript{293}

\section{5.5 A Comparison between the OECD and the USA}

\subsection*{5.5.1 Similarities}
Both under the OECD and the USA guidance is the PSM a two step method which aims to first establish the total profits from controlled transactions under review or a residual profit, and secondly split this profit under arm’s length circumstances.\textsuperscript{294} The profit which is allocated should be assigned to controlled transactions and be split under conditions which independent enterprises should have agreed upon.\textsuperscript{295} Any of the different PSM approaches could be suitable to employ in situations which involve industries with a level of vertical integration, such as the automobile industry.

\subsection*{5.5.2 Differences}
According to the OECD, the profit subject to be split should be based on either anticipated or actual profits and the valuation can be made in various ways and can either be the operating or gross profits.\textsuperscript{296} Thus, the USA standpoint is different from OECD, since the operating profits should be the profit subject to be split under the employment of both the comparable and residual approach.

The main difference in the OCED and the USA guidance is that a comparable operating profit is the main factor to consider when a USA PSM is employed. Since the OECD PSM is a transactional method, a comparable profit is just a part of the evaluation and more factors should be valued when a contribution or residual OECD PSM is applied.\textsuperscript{297} Thus, the USA approach can be considered to be less reliable since it put emphasis and rely more on internal comparables over external. However it might be positive from a practitioner point

\begin{itemize}
\item \textsuperscript{292} Markham, Michelle, \textit{Transfer Pricing of Intangible Assets in the US, the OECD and Australia: are Profit Split Methodologies the Way Forward?}, p. 11.
\item \textsuperscript{293} USA Transfer Pricing Regulations (1994), Treas. Reg. § 1.482-6 (c)(3)(i)(B)(2).
\item \textsuperscript{294} Miller, Angharad., Oats, Lynne, “Principles of International Taxation”, p. 224.
\item \textsuperscript{295} For instance please see TPG, Para. 3.11.
\item \textsuperscript{296} OECD, \textit{Proposed revision of Chapters I-III}, [page.33.], Para. 2.72. Also OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, Para. 3.15.
\item \textsuperscript{297} Markham, Michelle, \textit{Transfer Pricing of Intangible Assets in the US, the OECD and Australia: are Profit Split Methodologies the Way Forward?}, p. 13.
\end{itemize}
of view since the USA PSM could be more practical to apply.\textsuperscript{298} In step two, different from the USA, the OECD provides an option to put emphasis on the MNE bargaining position in the light of an analysis of such positions.\textsuperscript{299} Relevant independent companies might be found where in joint-venture arrangements.\textsuperscript{300} Though the OECD admits that it might be hard or even impossible to find such information, because uncontrolled transactions from where comparables can be obtained from might not exist.

\textsuperscript{298} Ibid, p. 21.
\textsuperscript{299} Ibid, p. 15.
\textsuperscript{300} OECD, \textit{Proposed revision of Chapters I-III}, [page.38.], Para. 2.94.
6 Application Guidance and Issues

6.1 Introduction

In practice, the PSM have become more acceptable in the recent decade and is employed more frequently. This acceptance is not always shared by tax administrations around the world since they still are less tolerant for the application of a PSM, although this trend is changing.\footnote{Markham, Michelle, Transfer Pricing of Intangible Assets in the US, the OECD and Australia: are Profit Split Methodologies the Way Forward?, pp. 15-16.} Difficulties might be encountered while a PSM is employed in order to determine a correct transfer price. The TPG do not read up on in detail how to assess the combined profit which arises from controlled transactions in which the AE are engaged.\footnote{OECD, Transactional Profit Methods: Discussion Draft for Public Comment, January 2008, [page. 55.], Para 174.}

Another issue which several OECD member countries acknowledge concerns the lack of harmonized accounting standards. This can create serious problems when determining the combined profits to be split. For instance, if profits from the different transactions before being combined are subject to different accounting standards e.g. regarding currency. Several OECD countries experiences that the hardest problem they face when applying a profit split method is to determine the combined profit to be split, for instance due to differences in the accounting standards of the involved countries.\footnote{OECD, Transactional Profit Methods: Discussion Draft for Public Comment, January 2008, [page. 55.], Para 176.}

6.2 Determine the profit to be split

6.2.1 Background

Fundamentally, before any profit can be allocated there are some necessary factors which need to be elucidated in order to measure an amount of appropriate profit pursuant to the ALP. First of all, only the controlled transactions which are pertinent, \textit{i.e.} the transactions to be utilized in the PSM, must be identified and consideration must also be taken to the level of aggregation. Secondly, it is required to identify the involved MNEs in relation to these pertinent transactions.\footnote{OECD, Proposed revision of Chapters I-III, [page.35.], Para. 2.78.}

According to the OECD, the combined profits to be allocated among the involved MNEs should derive the controlled transactions under examination and should not include any profit which arises from other transactions. It can either be a “total profit” which has been established under a contribution analysis or a “left over”, \textit{i.e.} “[a] residual profit which cannot be readily assigned to one of the parties”.\footnote{OECD, Proposed revision of Chapters I-III, [page.35.], Para. 2.78.}

Under a PSM employment, each involved MNE should seek to receive fair share of the profit subject to be split. The economically value of the undertaken contributions of each MNE is determined from the information collected in the functional analysis.\footnote{Markham, Michelle, Transfer Pricing of Intangible Assets in the US, the OECD and Australia: are Profit Split Methodologies the Way Forward?, p. 20.} For in-
stance, a similar amount of profit as independent enterprises would have expected to generate from a joint-venture partnership under comparable conditions, taking the functional analysis into account in order to establish an appropriate evaluation of each participant’s contribution.\footnote{OECD, \textit{Proposed revision of Chapters I-III}, [page.36.], Para. 2.83.} Hence, the division of profit should equal an amount which reflects the economical value of the conditions for every performed contribution in the controlled transactions under review.\footnote{OECD, \textit{Transactional Profit Methods: Discussion Draft for Public Comment}, January 2008, [page. 66.], Para.220. With reference to TPG, Para. 3.5.} Since independent enterprises cannot foresee whether the conditions in the comparable uncontrolled transactions will generate a profit (a loss can even occur) an assessment of the profit should preferably be based on expected profits instead of actual profits.

### 6.2.2 Projected or actual profits?

As mentioned above, a PSM can be employed in compliance with the ALP to either establish transfer prices or be used as a sanity check. When transfer prices in controlled transactions are established through a PSM, \textit{i.e.} the first-named situation, the OECD refers to the term “\textit{ex-ante}”.\footnote{OECD, \textit{Proposed revision of Chapters I-III}, [page.35.], Para. 2.81. With reference to TPG, Para. 3.11., since the source is based on this paragraph and edited.} Whenever a PSM is employed ex-ante, the projected profit should be divided among the MNEs and not the actual profit.\footnote{Please see OECD, \textit{Transactional Profit Methods: Discussion Draft for Public Comment}, January 2008, [pp. 66-67.], Paras.219 and 222. Also OECD, \textit{Proposed revision of Chapters I-III}, [page.35.], Para. 2.82.} However, this requirement should not be confused with the facts that the expected profits can perfectly well be based on actual profits from comparable uncontrolled transactions, \textit{e.g.} joint-ventures.\footnote{OECD, \textit{Transactional Profit Methods: Discussion Draft for Public Comment}, January 2008, [page. 66.], Para. 3.5.} Due to the difficulty a taxpayer encounter when estimating the expected profit and not actual profit, it is important that a tax administration acknowledge this hurdle in an eventual transfer pricing audit.\footnote{OECD, \textit{Proposed revision of Chapters I-III}, [page.36.], Para. 2.83.} As long as the valuation of profit was based on reasonable foreseeable information the taxpayer should not be penalized due to hindsight, as it would be inept to claim that the taxpayer should base the estimation on information which cannot be known in advance.\footnote{OECD, \textit{Proposed revision of Chapters I-III}, [page.35.], Para. 2.82.} 

### 6.2.3 Accounting Issues

Practitioners have expressed their concerns regarding the encountered difficulties to assess the correct amount of profit to be split. A prerequisite for establish a proper estimation of the total or residual profit are homogenous accounting standards in the countries where the evaluated MNEs are located.\footnote{OECD, \textit{Proposed revision of Chapters I-III}, [page.36.], Para. 2.83.} In situations where the accounting standards are dissimilar and thus might considerable affect the estimation of profits, relevant information from the

\begin{footnotesize}
\begin{enumerate}
\item [307] OECD, \textit{Proposed revision of Chapters I-III}, [page.36.], Para. 2.83.
\item [309] OECD, \textit{Proposed revision of Chapters I-III}, [page.35.], Para. 2.81. With reference to TPG, Para. 3.11., since the source is based on this paragraph and edited.
\item [312] OECD, \textit{Proposed revision of Chapters I-III}, [page.36.], Para. 2.83.
\item [313] OECD, \textit{Proposed revision of Chapters I-III}, [page.35.], Para. 2.82.
\item [314] OECD, \textit{Proposed revision of Chapters I-III}, [page.36.], Para. 2.84.
\end{enumerate}
\end{footnotesize}
MNEs financial accounting is generally used. Since the PSM is a two-sided method which evaluated each involved MNE, at least two of the MNEs though sometimes three or more, have its balance sheets and the consolidated statement of income established under two domestic accounting standards. Regardless of the choice of which accounting rules to use, it should be decided beforehand and apply similar to each MNE under consistent manners over the lifetime of the arrangement.

It is the generated profit from one or more, sometimes aggregated, controlled transactions which constitute the profits to be split. Thus, all the MNEs financial records must be homogenously put together regarding accounting and currency before the profits are combined. The special facts and circumstances of the situation, i.e. the function and comparability analyses, will determine how the profit should be estimated in the most appropriate manner, since the OECD favor a flexible approach and do not believe that a prescriptive set of criteria should provide a solution in this issue. Meanwhile, in order for this issue to be solved or at least facilitated for both taxpayers and tax authorities, the IAS/IFRS and US GAAP which are two of the main organizations of creating accounting standards aims to establish convergence in the future since they have a different set our accounting rules nowadays.

Although the OECD does not provide much guidance in how the profit should be assessed, some guidance can however be found. If cost accounting data exist, the OECD recognise that product-line income statements or segmented accounts can sometimes be the most appropriate financial information to utilize, prerequisite that these accounts are data are reliable and auditable. These costs must also be reasonable and independent enterprises should have agreed to spend a similar amount under comparable circumstances, according to the ALP. However, it has been noticed in practice that employment of multiple allocation keys to determine the costs (e.g. in cost-sharing arrangements) might lessen the reliability of the utilized data.

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316 Ibid, [page. 56.], Para. 181.
323 Product line can be defined as “A set of related products sold by a single company”. (http://www.investorwords.com/3877/product_line.html)
6.3 How should the Profit be Split?

An arm’s length allocation of the total or residual profit relies on the facts and circumstances of the situation, i.e. the functional analysis with emphasis put on the proliferation of risks among the MNEs will provides the best guidance to find relevant information. An allocation pursuant to the ALP should be based on either comparables from uncontrolled transactions or internal data, in combination (data) with relevant set criteria of how the profit should be divided in a constantly manner to each involved MNE. In practice, these factors combined create a so called “allocation key” and one or more allocation keys are used to allocate the profit. Criteria are used to decide whether the utilized data in an allocation key can be considered to be relevant and related to the controlled transactions under review. Even though the OCED points out that a prescriptive list of criteria or a number of predestined allocation keys would not be the best solution to deal with possible issues regarding the allocation of profit among the involved MNEs, some general guidance has been stated.

An allocation key must comply with a set of splitting factors and also be documented properly. These factors concern consistency, objectivity and capacity of being measured.

Firstly, regarding the measure factor, an allocation key must be capable of being measured in a reasonably reliable manner. For instance, the employer of the PSM whether a taxpayer or a tax administration, should be able to motivate why a PSM is suitable to apply on the situation in question and to demonstrate how the method shall be implemented. Especially with reference to how allocation key(s) should be used, i.e. how the splitting factors comply with the specific facts and circumstances of the case, in order to allocate the profits at arm’s length.

Secondly, an allocation key is not objective if based on information from the charged prices in the controlled transactions. Information from uncontrolled transactions such as sales to

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326 OECD, Proposed revision of Chapters I-III, [page. 32.], Para. 2.70.
327 The wording “external data” was used in OECD, Transactional Profit Methods: Discussion Draft for Public Comment, January 2008, [page. 66.], Para. 220. instead of “comparable uncontrolled transaction” which is used in the OECD, Proposed revision of Chapters I-III, [pp. 36-37.], Para. 2.86.
328 OECD, Proposed revision of Chapters I-III, [pp. 36-37.], Para. 2.86.
330 OECD, Proposed revision of Chapters I-III, [pp. 36-37, 39.], Paras. 2.96. and 3.21.
331 The General Requirements can be found in the OECD, Proposed revision of Chapters I-III, [pp. 32 and 37.], Paras. 2.69-71. and 2.86. And also the OECD, Transactional Profit Methods: Discussion Draft for Public Comment, January 2008, [pp. 66-67.], Paras. 220-223.
332 OECD, Proposed revision of Chapters I-III, [page. 32.], Para. 2.70.
333 Exact wording in both the OECD, Proposed revision of Chapters I-III, [page. 32.], Para. 2.70. and OECD, Transactional Profit Methods: Discussion Draft for Public Comment, January 2008, [page. 67.], Para. 221.
334 Exact guidance in both the OECD, Proposed revision of Chapters I-III, [page. 32.], Para. 2.71. And OECD, Transactional Profit Methods: Discussion Draft for Public Comment, January 2008, [page. 67.], Para. 222.
unrelated enterprises should be used instead, *i.e.* objective data.\(^{335}\) Furthermore, this information should however be “supported” by reliable information which is comparable. It can for instance be external comparables but also internal relevant data which can be utilized to support the “objective” data.\(^{336}\)

Thirdly, regarding the consistency factor which comprises three requisites which has been stipulated differently (however quite similar) by the OECD. In the OECD, *Proposed revision of Chapters I-III of the Transfer Pricing Guidelines 9 September 2009 – 9 January 2010* (Proposed Revision) these three requisites require an allocation key to be consistent with:

1. “[t]he functional analysis of the controlled transaction under review, and in particular reflect the allocation of risks among the parties”,
2. “[t]he determination of the combined profits to be split and of the splitting factors which would have been agreed between independent parties”,
3. “[t]he type of profit split approach (e.g. contribution analysis, residual analysis, or other; *ex ante* or *ex post* approach (…))” \(^{337}\)

In the OECD, *Transactional Profit Methods: Discussion Draft for Public Comment*, January 2008 (Transactional Profit Method Draft) these three requisites require an allocation key to be consistent with:

1. “[t]he comparability (including functional) analysis of the controlled transaction under review, and in particular reflect the allocation of risks among those parties (subject to the risks being real and the allocation of risks being at arm’s length, see paragraph 1.27 of the TP Guidelines)”,
2. “[t]hose which would have been agreed between independents in comparable circumstances, given the profit split method seeks to determine the division of profits that independent enterprises would have expected to realize from engaging in the transaction (see paragraph 3.5 of the TP Guidelines)”,
3. “[t]he type of profit split approach (e.g. contribution analysis, residual analysis, or other; *ex ante* or *ex post* approach).” \(^{338}\)

The described guidance should be used over the life-time of the arrangement (during loss years as well) with the exception of when “specific circumstances” occurs, for instance an economical downturn.\(^{339}\) Such event would have required a re-negotiation of the stipulated conditions in the entered arrangements under a joint-venture between independent enterprises.\(^{340}\) Finally, an additional and essential factor which must be taken into consideration

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\(^{336}\) Added guidance in the OECD, *Proposed revision of Chapters I-III*, [page. 37.], Para. 2.86. Before, it was found in OECD, *Transactional Profit Methods: Discussion Draft for Public Comment*, January 2008, [page. 67.], Para. 223. but with the wording “external data” instead of “reasonable reliable comparables data”.

\(^{337}\) OECD, *Proposed revision of Chapters I-III*, [pp. 32-33.], Para. 2.70.


is to determine an appropriate period of time for which the utilized splitting factors in the allocation key should account for.341

6.4 Allocation Keys

6.4.1 Background

In practice, an allocation key is commonly a figure or a variable depending on what is most suitable in the case. The figure can be a percentage based on the information of general splitting factors described above, i.e. with the overriding objective to allocate the profits according to the ALP under conditions as independent enterprises would have agreed upon.342 For instance when the profit has been established, the utilized criteria in an allocation key can be a figure such as “60% and 40%” by reference from comparable uncontrolled transactions regarding a joint-venture development project.343 Unless comparable transactions do not exist, for instance due to unique contributions in the controlled transaction, internal data should be utilized to support the division of profit.344 However if a variable is employed, the “relative value” of an appropriate “key” are usually connected with contributed value-driver functions and is more likely to vary from year to year different from the figure.345 It can for instance be the relative value of one or more MNE’s investments in R&D.346

6.4.2 Different types of allocation keys

In general, there are two types of allocation keys which are commonly employed in practice and these are either based on assets are on costs. The most appropriate base to use depends on these contribution which are the value-driver functions.347 For instance, such keys can be used prerequisite that a strong correlation exists between the value-drivers and the either contributed tangibles, intangible assets, invested capital or a combinations of these three types of contributions. A third type of allocation key which is based on the capital employed of every participated MNE can also be used under certain circumstances.348

6.4.3 Allocation Keys based on Asset

The OECD provides a number of examples regarding asset-based allocation keys, which can be for instance be based on operating assets349. These kinds of allocation keys can also

341 OECD, Proposed revision of Chapters I-III, [pp. 38.], Para. 2.93.
343 OECD, Proposed revision of Chapters I-III, [page. 38.], Para. 2.94.
344 OECD, Proposed revision of Chapters I-III, [page. 39.], Para. 2.95.
346 OECD, Proposed revision of Chapters I-III, [page. 37.], Para. 2.88.
348 OECD, Proposed revision of Chapters I-III, [page. 40.], Para. 2.99.
349 Operating assets can be defined as “Asset which contributes to the regular income from a company’s operations.” (http://www.investorwords.com/3456/operating_asset.html)
be based on “fixed assets” such as inventories of considerable book value (e.g. production lines, machines) or buildings such as real estate. A main characteristic for these types of assets is that they cannot easily be converted into money/cash.

The OECD read up on one particular situation where the PSM probably would to be the most appropriate method to employ and allocate the profit with an asset based allocation key. This is when the both parties to the (controlled) transaction contribute significant unique intangibles. In practice intangible assets pose difficulties since it is hard to identify intangible assets and to evaluate them correctly. For instance, if an intangible asset’s value is not entered into the bookkeeping. The identification issue might also concern the absence of legal protection (e.g. patent) since only relevant intangibles should be regarded, i.e. intangible assets which used in the controlled transaction, and not other intangibles which might be contributed in other controlled or uncontrolled transactions. As the PSM is a two-sided method which examines every involved MNE in the controlled transaction, it is essential to identify which MNE owns what intangible assets and to establish the relative value of each contributed intangible asset.

### 6.4.4 Allocation keys based on costs

Occasionally, it can be understand from the function analysis with special regard to risks, that value-driver contributions instead have a stronger correlation to certain expenses instead of assets. Thus, it is more appropriate to employ cost-based allocation key(s). A positive element with cost-based allocation keys is their practical employment since they are considered to be convenient to employ. For instance regarding a reseller MNE, where the marketing actions create much value to the controlled transaction and these expenses can assumingly be readily extracted from the balance sheet. Investment expenditures which have resulted in a successful developed R&D contribution which create a significant value will most likely be a main value-driver. For instance for manufacturing MNEs which imposes a unique technical feature prerequisite that the development result has been founded and are owned by the manufacturing. However, sometimes more than one MNE contributes with two or more different value-drivers e.g. intangibles. Under such circumstances

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530 Fixed assets can be defined as “A long-term, tangible asset held for business use and not expected to be converted to cash in the current or upcoming fiscal year, such as manufacturing equipment, real estate, and furniture.” (http://www.investorwords.com/1988/fixed_asset.html)


would the application of one or more cost-based allocation key(s) provide an unreliable allocation of profit, *i.e.* contrary to the ALP, if not the R&D expenses would be an appropriate measure for all relevant value-drivers. It is commonly practiced that the amount of compensation expenses for "people-functions" can be used in a cost-based allocation key. Such an allocation key might be appropriate to apply regarding the financial market where actual persons can be considered to be the main value-drivers.  

A cost-based allocation key may have negative attributes as well. Its reliability will lessen in proportion to the level of disharmonized domestic accounting standards of the involved MNE. For instance, certain R&D expenditures might be booked as a cost under one AE domestic standards while it would not be deductible under another AE’s record keeping rules. Even if certain expenditures are regarded to be costs under a number of domestic however homogenous accounting systems; issues might still incur since the level of costs differ *e.g.* due to labour-costs which can be significantly dissimilar worldwide. Examples of labour cost can be salary, fringe and bonuses.

### 6.4.5 Allocation Key based on Capital Employed

Another possible approach is to split the combined profit so that each MNE which participate in the controlled transaction earns the same rate of return on the capital it employs in that transaction. However, the OCED consider this to be an allocation of last resort. Capital employed is the sum of fixed assets (described above), but also added with other assets which can be converted into money in less than a year (*i.e.* current assets) and then subtracted with the total amount of borrowed money which should be paid back within a year (*i.e.* payables). This allocation assumes that each and every capital investment of every involved MNE is subject to a similar level of risk. Thus, it can be assumed that the involved MNE’s earns the similar rate of return as independent enterprises would have agreed upon. According to the OCED such an assumption can be unreliable since it might ignore important factors which can be identify in a proper established functional analysis. For instance, capital employed may not regard dissimilar capital market conditions properly.

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361 Fringe benefits can be defined as "Non-salary employee compensation". (http://www.investorwords.com/2095/fringe_benefits.html)


364 Capital Employed can be defined as "Fixed plus current assets minus current liabilities. Capital employed is the value of the assets that contribute to a company’s ability to generate revenue." (http://www.investorwords.com/5440/capital-employed.html)

365 TPG, Para. 3.24.

7 Analysis

7.1 Introduction

The previous chapters have presented a fundamental guidance on the OECD and USA regulations of the PSM. A number of issues arose around the PSM when this information was assembled and stringed together into an analysis.

The main purpose of this master’s thesis is to investigate whether today’s existing regulations provide sufficient guidance on how to apply PSM in practice. The analysis will draw some conclusions of certain transfer pricing situations where the different PSM approaches are most appropriate to employ. A prerequisite which should be achieved in order for any of these approaches to be “most appropriate” or “best” is to provide a fair result, in accordance with the guidance set out in the TPG. The USA regulations will also be considered to some extent regarding the Comparable PSM. Another purpose of this master’s theses was also answered in the analyzing process; whether PSM method would come in conflict with other TPM or not.

7.2 Is there a Need for More Guidance on PSM?

In the previous years, before the OECD issued the TPG, there was not much guidance of interest published which concerned the application of PSM. When the TPG was issued in 1995 it gave PSM more acceptance, although as a method of last resort. As of today, it was 14 years since the TPG was published and much has happened since; both in the area of transfer pricing and in the economical environment.

Transfer pricing is a consequence from economical decisions and not merely tax-planning, which only constitute one part to consider. It should not be confused with price manipulation either. Transfer pricing guidance can instead be seen as a judgment tool to share the cake between the taxpayers and the tax authorities under fair conditions. However, such an aim require regulations and guidance which applies in an equally manner for all the involved participants, in order to provide meaningful result. This standpoint is shared by a leading developer in transfer pricing area, the OECD. Compared to the USA, which is another main developer, the OECD are more objective in that neutrality perspective since the USA is keener to protect its own tax base. Neutrality is a hard task to achieve since the OECD platform strives to serve the interests of 30 different countries (including the USA ironically). The OECD favors a rather “general” approach in its transfer pricing guidance and is different from the USA, which present a more prescriptive set of rules. It therefore makes sense that the USA is rather partial and do not consider the mass as a whole.

Ultimately, it is the taxpayers and the tax administrations around the world which will actually utilize the existing transfer pricing guidance and regulations. If these rules are disregarded they sometime impose severe consequences such as double taxation, which might affect the economical decision-making in a MNE group. Issues can arise from the dilemma of disharmonized transfer pricing regulations if one OECD country provides a more prescriptive set of guidance, while the OECD are too general. Some matters are subject to be interpreted under domestic law, for instance the definition of an AE. Due to the absence of detailed guidance in any transfer pricing matter, a practitioner might seek for guidance where it can be found in order to obtain some kind of support, for instance concerning the employment of a PSM. Irrespectively if the guidance is rather partial than objective and this circumstance favors nations such as the USA. An application based on a more “general” guidance increases the risk for interpretation and perhaps penalties as an unwanted conse-
quence. Therefore is more prescriptive guidance from the OECD which concerns the PSM desirable.

### 7.3 Situations when the PSM can Provide a Suitable Solution

#### 7.3.1 Background

PSM has gained international acceptance and is used more frequently nowadays. Especially in transfer pricing situations when the business environment is characterized by a complex integration, such as the automobile industry. An industry that also consist a proliferation of controlled transactions which involve intangible assets; another situation where a PSM is most likely the appropriate method to apply.

It is required that the taxpayer establish a thorough broad base, functional and comparability analysis, in order to apply PSM in a reliable manner. The primary aim with the broad base analysis is to identify all the undertaken controlled transactions between the AE. After the controlled transactions have been identified they need to be evaluated in order to clarify whether transfer prices are within an arm’s length. Transfer prices which do not correspond to the ALP are subject of being adjusted by a tax administration in the country where the AE with the incorrect price is located. An adjustment might lead to double taxation if the tax authority in the other country does not make a corresponding adjustment to counter balance the primary adjustment.

#### 7.3.2 Will PSM come in Conflict with other TPM?

In order to examine whether the PSM is the most appropriate TPM to employ, the starting point is to sort out in brief whether any of the other TPM are suitable to employ instead. However, the OECD does not require the taxpayer to undertake a thorough test of the outcomes of different TPM, contrary to the USA according to the best method rule.

The OECD read up on five different TPM which can be employed. As of today, the OECD considers three of these methods to be more reliable than the two others when they can be applied in an equally reliable manner. However, the proposed revision will almost certainly ascend the other two “methods of last resort”, *i.e.* the PSM and the TNMM, and change the current method hierarchy. The method which is most appropriate should instead be employed and it can perfectly well be the PSM depending on the facts and circumstances of the case. Vice versa, if any other method than the PSM would be more suitable it should be employed. For instance, if comparables prices of the controlled transactions can be readily obtained, a CUP should be used. If the controlled transactions consist of contributions of routine functions alone, a one-sided method such as the RPM, C+ or TNMM is most likely the most appropriate to employ, provided that reliable comparables can be readily obtained. There is however some characteristic situations where a PSM probably will be the most appropriate method to apply. First, in situations where a comparable price cannot be found and where a one-sided method lack in reliability. A one-sided method mainly put emphasis in the least complex party for which benchmarks can be obtained. It does not provide an appropriate solution in situations for when it cannot readily be assigned which MNE who actually performs the different contributions. The second typical case is when two or more MNE contribute with valuable functions for which comparables cannot be obtained.

To sum up; the PSM method will most likely not come in conflict with other TPM. A residual PSM can even be employed as hybrid where other TPM are used to assess routine functions regarding these contributions for which reliable comparables exist.
7.3.3 The Importance of the Functional Analysis

The functional analysis is a necessary tool used to investigate whether any of these typical PSM situations exist but also to examine whether suitable comparables can be obtained. The purpose of functional analysis should not be mixed up with a search for comparables, since this is the objective of a comparability analysis. A proper established functional analysis will instead provide guidance to find out where these comparables might be obtained and which comparables to utilize in the comparability analysis.

A proper established functional analysis should also enable the practitioner to perform a correct extraction of controlled transactions, as it sometimes might be necessary to segment certain controlled transactions from others, i.e. the relevant ones are under examination. For instance under circumstances where a residual PSM would be appropriate to employ, since it perfectly well can be the case that a part of the identified controlled transactions transfer prices can be assessed by other TPM. The one(s) which remain(s) will thus be subject to a residual PSM.

Lastly and the most important factors to identify in the functional analysis are the so called “value driver” functions and to consider which risk are taken by which MNE. A value driver is a function, risk or used asset (or a combination of them) which generate the significant profit as it imposes value to the controlled transaction in a larger compass. Value drivers are often associated with entrepreneurial characteristics which for instance can be unique performed functions or used intangible assets and high risk taking. To conclude, a well established functional analysis should reflect where the value is created in the light of performed contributions, undertaken risk and used assets.

7.4 Typical PSM Transfer Pricing Situations

7.4.1 Background

Typical transfer pricing situations involves two main characteristics and the first is high integration; both horizontal and vertical as the economical environment in the automobile industry. Secondly, the circumstance when two or more MNE performs unique contributions to the controlled transactions.

A common feature regarding these typical situations is the absence of reliable comparables due to performed functions which consists of unique contributions. Since comparable cannot be obtain to use in other TPM, the PSM is most likely to be the most appropriate TPM to employ since it does not rely on closely comparables in the same extent as the traditional TPM does. Though under non-complex situations, for instance an absence of complex integration or the fact that only one MNE contribute with value unique function for which comparables cannot be found, a one sided method such as TNMM would be preferable anyhow. Although it is a positive ability that the PSM is a two sided method, in practice it can also be negative since a two sided method is more expensive to employ from the taxpayers point of view. The costs should be in proportion of the use and a cheaper alternative such as the TNMM might be more appropriate. Therefore, prerequisite that every other TPM has been rejected, a PSM might be the only method which can offer a solution and set transfer prices in accordance to the ALP.

However, there is one other typical situation which is not carefully described in TPG, where the PSM might be the most appropriate method to employ. This circumstance is when a MNE acquire an independent company which performs unique contributions. Assume that the MNE does not employ a PSM in its current TP policy. Under such a cir-
circumstance the policy is required to be changed in order to comply with the ALP and to avoid the risks of a possible double taxation dilemma. Depending on whether acquired company is “grey” or “black and white” in its performed functions, a contribution or residual might be most appropriate.

7.4.2 When a Contribution PSM is Most Appropriate

A contribution approach is probably most useful when the involved enterprises functions cannot readily be classified to be either routine or entrepreneurial contributions. The company structure might be very integrated and most MNE contribute with routine contributions but also with entrepreneurial functions as well to some extent. It could be value drives such as a unique production technique which are shared by several manufacturing MNE, e.g. in the automobile industry. It would therefore be very difficult and thus unreliable to employ a residual allocation of the profit since a “grey zone” exists.

A contribution approach put emphasis on the total economical value for the sum of contributions, which each involved MNE add to the profit in controlled transactions under review. For instance, value drivers of both routine functions and entrepreneurial functions along with the respective undertaken associated risks, are evaluated in order to assess the economically value of these functions according to the ALP. The functional analysis might also guide the practitioner or tax authority to find reliable and relevant comparables from independent enterprises which undertakes comparable contributions. The contribution approach can still be useful when no comparables exists. The evaluation can be based on relevant internal financial data which can be extracted from the MNE financial statement. Also, as actual profits are shared neither MNE will be receiving a disproportionate result. On the contrary, a residual PSM will probably be more reliable than a contribution PSM if some comparables can be obtained and be utilized in other suitable TPM in order assess the remuneration for routine functions.

To conclude: A contribution PSM divides the entire profit among the involved MNE, based on the economical value of the each party’s contribution, which in general can be assigned to the operating profit. No “residual” arises which cannot be readily assigned to a specific MNE. This circumstance is the main difference compared with the Residual PSM.

7.4.3 When a Residual PSM is Most Appropriate

The major difference from a contribution approach is that a residual allocation of profit is most useful when the functions of the involved MNE can readily be classified to be either routine or entrepreneurial contributions in a “Black and White” manner. Thus, it will be less difficult (not easier) to assess the economical value of the different contributions and the remuneration which can be assigned to the routine part of the profit will most likely result of an allocation in accordance to the ALP.

Another difference is when the “bargain residual approach” is used. This approach can be considered to be a hybrid of the contribution and residual PSM. An economic valuation of each party’s contribution to the (operating) profit is required in a manner akin to a valuation under a contribution approach. In step two, a Residual allocation of profit is performed in the same manner as in a “regular” residual approach.

7.4.4 When a Comparable PSM is the Best Method

A Comparable PSM can preferably be employed if one of the AE is located in the USA. This method cannot be employed unless reliable external data can be obtained, since the
method require a comparison of the taxpayers operating profit with the operating profit from comparable independent enterprises. The operating profit should be attributed to comparable contributions which generate profit, e.g. return on invested capital.

Some practical problems will probably occur while using this method. First must the relevant indicator be identified to assess the operating profit. It can be hard to obtain the relevant information from the AE which can be utilized, due to specific country restrictions. Thereafter, if that can be successfully handled, the next step is to find comparable enterprises and the same relevant information concerning the contributions which the comparable operating profit can be attributed to. The more this comparability factor varies the less reliable will the method become. A Comparable PSM cannot be employed if the comparability factor is too unreliable since it would be contrary to the best method rule. Under such circumstances, a one-sided method might provide a reliable transfer price provided that relevant information can be obtain for one of the involved AE. Another issue can arise if the contributions in the controlled transactions under review consist of intangible property which is unique. It might be hard to determine the economical value of that contribution. The taxpayer or tax authority may also encounter difficulties to find a contribution which consist a comparable intangible and the operating profits cannot therefore be compared in a reliable manner.

To sum up; if one of the involved taxpayers should be located in the USA and if external comparables which are reliable can be obtained to make a correct comparison of the operating profits, a comparable PSM might be the best method to employ. Reliable comparables must be obtained from independent enterprises which performs comparable functions. Hence, the operating profit can be compared between the taxpayer and the independent enterprises in a reliable manner according to the best method rule.

7.5 Practical Issues when Applying a PSM

7.5.1 Introduction

There are several practical issues which may be encountered when a PSM is applied. Firstly, it may sometimes be hard to disentangle the relevant controlled transactions due to high level of integration within the company group. Secondly, the controlled transactions high value-driver functions might be attributed to more than one intangible asset performed by two or more MNEs for which no comparables can be obtained. Thirdly, it will most likely be difficult to evaluate the intangible property assets and other unique contributions. Thus, it can be hard to determine a correct combined or total profit subject to be split under either a contribution, residual or “bargaining” approach. Fourthly, practical issues might also be encountered when the profits should be allocated in accordance with the ALP and an example of such problem will now be presented below.

7.5.2 Examples of the Employment of an Allocation Key

A practical problem can be the difficulty to receive reliable information both regarding external comparables and internal comparables to be utilized in suitable allocation keys. Even when comparable information can be obtained, differences in cost-record system and account standards materially might affect the utilized information in the allocation keys and lessen the reliability.

Sometimes it might be appropriate and rather easy to allocate the profit by reference to the total number of people which is involved in the controlled transaction among each MNEs contribution of people, i.e. headcounts. Thus, an allocation of the combined operating
profit could be explained in this basic example. If MNE (A) contributes with three peoples, MNE (B) with five peoples and MNE (C) two peoples; an allocation key (variable) based on headcount would allocate 30% to MNE A, 50% to MNE B and 20% to MNE (C), presupposed that all involved people generate a similar among of profit. This allocation can be made since no comparables is required and the allocation key can be supported with reliable information, *i.e.* it can be demonstrated that the involved people are value-creating (generates profits), *e.g.* since no other used assets exists and it legal services which are provided.

However, assume that a cost-based allocation key is employed and the expenses for R&D are a value driver. MNE (A) and MNE (B) has 50 units each in annual R&D in expenses and the residual profit which can be attributed to R&D should be shared equally, *i.e.* a 50% split. According to the functional analysis and other relevant splitting factors, this cost based allocation key will split a residual profit at arm’s length, so far so good. Though a practical problem which might occur is if the local manager in one of the AE has a bonus system with his bonus connected to the annual reports. Assume that the local manager want to make a good result during one year and thus receive a higher bonus than usual. The manager therefore decide to not spend all 50 units expenses on R&D and chooses to put 40 units on the balance sheet as a dept and only 10 in the annual statement (operating expenses). This will most likely create a problem since it will be unreasonably to argue for an equal allocation of the profits, since only one of the company actually record the total costs of 50 units while the MNE (B) with local manager bonus system only record 10 in the annual statements and 40 in the balance sheets.

This latter example illustrate that the complexity of real life and the existing application guidance has not reached the same level of development. Hence, it can sometimes be hard to thoroughly fulfill every application requirement which should be met in theory. For instance the objective splitting factor which does not allow an allocation key to be based on suitable information from controlled transactions alone, especially since the OECD requires that a solution always must be found to every transfer pricing situation. Therefore should the OECD allow “tailor-made” solutions in the situations where the OECD lack to provide guidance which present an answer, prerequisite that no reliable external comparables can be obtained. The allocation key in this example may for instance require to be based on internal financial data alone, *i.e.* both capitalized and operating costs, in order to provide a reasonable solution.
8 Conclusions and Recommendations

8.1 Introduction
The main purpose of this master’s thesis is to explain and analyze whether today’s existing regulations provide sufficient guidance in how to apply PSM in practice. The Arthur of this master’s thesis has identified three key conclusions which might facilitate how PSM issues can be dealt with in the future and improve the existing PSM guidance. These conclusions are the need for a uniform PSM interpretation, the need for additional flexibility and acceptance, and the need for additional TPG guidance. This chapter presents a discussion regarding the conclusions followed by some recommendations.

8.2 What Needs to be Done by the OECD?

8.2.1 The Need for a Uniform PSM Interpretation
PSM is perhaps the most fair and best TPM in theory due to its two sided nature which examine every involved taxpayer in the controlled transaction. A PSM evaluate “the whole picture” more thorough, for instance compared to a TNMM which focus more on the tested party which is the least complex. It is functions of the MNE, both routine and entrepreneurial, that constitutes a foundation which allows a determination of the total profit and allocation of that profit according in accordance with the ALP.

Information which is utilized to establish a proper PSM must however be documented by the taxpayer in a manner which demonstrates that a PSM is the most appropriate TPM. The documentation should enable the tax authority to use the information and control if the profit and allocation is at arm’s length by calculating themselves. As a consequence, the employment of a PSM will be a more expensive affair for the taxpayer in practice. More time is spent by the practitioner to examine the functions and searching for reliable comparables. These costs must be reasonable or else might another TPM be more appropriate to apply. Expenses must be in proportion with the gain advantages, even though the ALP applies equally to all MNE regardless of the size. It can however be argued other mandatory information which needs to be documented are obtained in connection with the employment of a PSM, and thus save some expenses.

The OECD states that taxpayers and tax authorities shall “exercise judgment” in deciding whether the information which is obtained is reliable enough, or if another search for comparables should be made. A problem will occur if the taxpayer and tax authority exercise a different judgment. It is indeed hard and almost impossible for the tax authority to challenge the taxpayers calculated profit and allocation which is based on internal data alone since no external data exist. Even though this data is best due to the specific facts and circumstances of the case, it can still be considered to be a rather subjective judgment since the OECD does not allow an allocation key to be based on suitable information from controlled transactions alone. There are always at least two tax administrations which must agree upon the profit split in order to avoid trouble for the taxpayer. If any of these tax authorities present a reluctant standpoint regarding the method choice a problem will occur.

Recommendation: An uniform PSM interpretation should diminish the risk of possible conflicts between taxpayers and tax administrations. It should also promote the taxpayers invest money to apply PSM, which is a more in depth TPM than TNMM for instance. The OECD should therefore provide further PSM guidance that consists of a wider range of flexibility and acceptance which meet the needs of today’s MNE groups.
8.2.2 The Need for Additional Flexibility and Acceptance

Transfer pricing is not an exact science and transfer pricing situations can be unique in their kind. There is a logical correlation between complex functions and the lack of reliable comparables since they might not exist. The OECD recognize that a solution must always be found in every transfer pricing situation but also that comparables cannot always be obtained and that the economical environment constantly changes. It is therefore impossible for the guidance to be complete but it can nevertheless be better and accommodate the needs of today’s MNE groups.

This goal might be a hard task to achieve since many factors should comply with each other. Flexibility in transfer pricing methodologies is thus desirable to strive at from a practitioner’s point of view. The OECD appear to present a more acceptable standpoint and willingness to accept the application of a PSM in the proposed revision, due to the difficulties which might be encountered in the process of determine an appropriate arm’s length price. Especially regarding controlled transactions of intangibles which are contributed by two or more MNEs. Practitioners encounter incomparable situations more often nowadays and because cross border trade increases, so does the complex cases due to higher integration and contributions of intangible property.

Several OECD countries, for instance Sweden, consider PSM to be the second best alternative method to employ prerequisite that one of the traditional transactions methods cannot be employed (i.e. the CUP, RPM and the C+). PSM might be a way forward and the next generation of TPM since it can provide a solution in complex transfer pricing situations. In particular when the facts and circumstances involve a high level of vertical integration and/or if the controlled transactions under review consist of intangible assets which are contributed by more than one MNE. Under such circumstances is it necessary to allow the guidance to be more flexible and accommodate the needs of every MNE group. Additional acceptance supports a view where only one method is needed to set transfer prices in accordance with the ALP, i.e. the most appropriate method.

Recommendations: Today’s existing transfer pricing guidance and practice does not present enough guidance for both taxpayers and tax authorities to exercise judgment in similar manners. This fact distorts the aim and ambition to harmonize transfer pricing guidance. The OECD should therefore allow taxpayers to be more flexible and accept “custom made” solutions which provides an appropriate solution to the specific situation in the light of the industry the MNE operates within.

8.2.3 The Need for Additional TPG Guidance

The use of PSM will most likely increase in the near future and more guidance needs to be issued by the OECD in order to create a uniform transfer pricing environment. It is desirable that detail guidance is presented which provide additional information about situations where a PSM would be the most appropriate method to apply.

Recommendations: Further guidance on how to determine the profits under a Contribution and Residual approach is desirable. Guidance is also needed which describes “grey areas”, i.e. where MNEs contribute with both routine and entrepreneurial functions. It is however positive that the OCED emphasis more on the relevance of the functional analysis in the proposed revision. However, more definitions in the TPG glossary could be useful, e.g. regarding the following terms: routine function, entrepreneurial function, benchmarkable function, unique contribution, internal comparables, external comparable, one-sided method, two-sided method, etc.
The OECD should moreover provide additional examples regarding different industries and examples of various functions as well (both routine and entrepreneurial) along with detailed guidance on how these functions can be evaluated on an economical basis. The detailed description should consist of recommended information which can be utilized in order to calculate the economical value. It is also desirable that OECD allow the allocation keys to be custom made in order to meet today’s transfer pricing environments. Especially on how the allocation of profit should be allocated.

Finally, additional guidance is needed regarding a hierarchy of comparables but also regarding criteria, i.e. the useful information that demonstrate and decide upon which data to utilize in allocation key to assess profits or allocations when no comparables exists.
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