Transfer Pricing: Transactional Profit Methods
Now more accpetable?

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Tax administrators world over, as also OECD, have come to realise the inherent limitations of traditional transaction methods and in the process Transactional Profit Methods have gained greater acceptance than before. This is evident from the suggested amendments in 'Transfer Pricing Guidelines for Multinational Enterprises and tax Administrators' issued by OECD in 1995. [Transactional Profit Methods – Discussion Draft For Public Comments -25/1/2008]. They are no longer transfer pricing methods of last resort.

All the Transfer Pricing Methods aim to achieve best possible approximation of arm's length price in accordance with Article 9 of OECD Model Tax Convention.

While traditional transaction methods are:

- Comparable Uncontrolled Price method
- Resale Price Method
- Cost Plus Method ;

transactional profit methods are – transactional net margin method (TNMM) and Profit Split method (PSM).

If comparable and reliable data of uncontrolled transactions (internal or external) is available, there cannot be dispute as to their preference. However, the fact remains, that more often than not it is not available. Main culprit is the format of the available data. At times it could be for genuine reasons of peculiarity of the business but quite frequently it is driven by individual needs of the enterprise to present the data in a preferred format of their own. Dissimilarity of the format makes comparison a very difficult task and adjustments unreliable. Calculation of gross margins of operations, if made strictly uniform, there will be grievance of its being not fit for taking well informed management decisions.

On the other hand, transactional profit methods, especially Transactional Net Margin Method takes care of variance in formats of presentation as accountant's decision to consider any particular expense below or above gross margin level remains no longer relevant.

Profit Split Method has somewhat limited applicability. It is used in cases where, for example, there are significant non-benchmarkable contributions by each party to a controlled transaction or cases where transactions are very integrated and they cannot be evaluated on separate basis. The profit split method first identifies the total profits earned by all the parties to the controlled transactions. It then splits those profits from the controlled transactions on an economically valid basis that approximates the division of profits that would have been anticipated and reflected in an agreement made at arm's length basis. This method, thus, offers a solution for cases where there are no reliable comparables because of high integration of functions, assets and risks of the parties concerned or where unique intangibles or assets are involved.

The transactional net margin method (TNMM for short) examines the **net profit margin** earned in a controlled transaction (or transactions that are appropriate to aggregate) with reference to an appropriate base- which could be costs, sales or assets etc. The net margin earned from controlled transactions (or aggregate of transactions) relative to an appropriate base is then compared to similarly computed net margin earned from uncontrolled transactions. Those uncontrolled transactions should preferably be 'internal comparables' and only when it is not possible, external comparables can serve as a guide. Of course, before those transactions could be called comparable transactions, a functional analysis of both transactions- controlled as also uncontrolled, is required to be done. If such analysis shows up some differences, then appropriate adjustments may be necessary to obtain the reliable results.

According to original Transfer Pricing Guidelines issued by OECD in 1995, transactional profit methods were to be resorted to only when traditional transaction methods could not be reliably applied alone or exceptionally could not be applied at all. Transactional profit methods were grouped under the heading 'Other' methods which obviously relegated those methods to secondary methods of determining transfer price at arm's length principle. In view of this, tax administrator world over looked down upon transactional profit methods, (TNMM method in particular) and considered it as not so a valid transfer pricing method. It was also because of observation of OECD that "enterprises rarely if ever use a transactional profit method to establish their prices." (Paragraph 3.2- Chapter III). Earlier Transactional Profit Methods were acceptable only in those exceptional cases where the complexities of real life business put practical difficulties in the way of the application of the traditional transaction methods and provided all the safeguards especially provided in Chapter I and III of the Guidelines were observed.

However, now transactional profit methods (Profit Split Method & Transactional Net Margin Method) have been accorded status of a more acceptable method of Transfer Pricing. Paragraph 3.2b of Chapter III of the Transfer Pricing Guidelines (as proposed in the aforesaid discussion draft) reads as under:

“3.2b *Transactional profit methods may be more appropriate than traditional transaction methods in cases where, for example, in consideration of the comparability (including functional) analysis of the controlled transaction under review and of the evaluation of the comparable uncontrolled transactions, it is found that a net profit margin analysis is more reliable than a gross margin analysis (e.g. because there are operating expenses below the gross margin level for which the tested party is not responsible); in cases where the presence of significant non-benchmarkable contributions (e.g. intangibles) by each of the parties to the controlled transaction or the engagement in highly integrated activities makes a transactional profit split more appropriate than a one-sided method; and in cases where there are no reasonably reliable satisfactory internal comparables, and no or limited publicly available gross margin information on third parties to apply a traditional transaction method in a reasonable reliable manner and where a transactional profit method can be applied in a reasonably reliable manner.”*

It is not that now Transactional Profit Methods could be applied automatically simply because there is difficulty in obtaining comparable data. Applicability of these methods is to be evaluated on the same standards on which applicability of traditional transactional methods is to be evaluated, especially those relating to reliability of adjustments to be made to the comparable data. In any case, Transactional Profit Methods are acceptable only if they are compatible with Article 9 of the OECD Model. OECD has also put a caveat on tax administrators and advised them that Transactional Profit Method should not be used so as to result in over-taxing enterprises mainly because they make profits lower than the average, when the reason for their lack of success and lower profits are attributable to commercial factors.

The point is when OECD has accepted transactional profit method as an adequately acceptable method of transfer pricing, how far the insistence of revenue authorities on traditional transaction methods in preference to Transactional Profit Method is justified? The issue assumes greater importance in the context of India and similarly placed countries where statutory disclosure norms in respect of financial data are not so demanding. All transfer pricing methods are essentially dependent on availability of comparable data in public domain, and disclosure norms do not require adequate disclosures, what does a sincere enterprise does to comply with transfer price regulations. The problem is compounded when presentation of financial data is made in a format which best suits the enterprise needs vis-à-vis its stakeholders (government excluded). It is hoped that disclosure norms and their compliance will put in enough financial data in public domain once the IFRS is in place. But again it will have to seen as to how stringent are the disclosure norms as to the amount of information as also their format. But the matter will not end there. It undermines the ingenuity of the innovative accountants.